91-375

(1)

No. _____

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1991

JIM C. PLEDGER, DIRECTOR OF THE ARKANSAS DEPARTMENT OF FINANCE AND ADMINISTRATION, TIM LEATHERS, COMMISSIONER OF REVENUES, AND JIMMIE LOU FISHER, TREASURER OF THE STATE OF ARKANSAS ..... *Petitioners*

vs.

STANLEY BOSNICK AND WILLA S. LINDSEY, GEORGE E. STEWART, DON LANE, JOHN SANDFORT, WILLIAM DAWSON BARLOW AND HANK GAJDA, ON BEHALF OF THEMSELVES AND ALL OTHER SIMILARLY SITUATED TAXPAYERS ..... *Respondents*

ON WRIT OF CERTIORARI
TO THE SUPREME COURT OF ARKANSAS

PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF ARKANSAS

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QUESTIONS PRESENTED FOR REVIEW

I.

DOES THE DOCTRINE OF INTERGOVERNMENTAL TAX IMMUNITY AND 4 U.S.C. §111 PROHIBIT A STATE FROM TAXING PENSIONS OF MILITARY RETIREES AND RETIREES FROM EMPLOYMENT WITH OTHER STATES AND THEIR POLITICAL SUBDIVISIONS WHILE EXEMPTING FROM TAXATION THE PENSIONS OF ITS OWN RETIRED EMPLOYEES?

II.

MUST THIS COURT'S DECISION IN DAVIS V. MICHIGAN DEPARTMENT OF TREASURY, 489 U.S. 803 (1989) BE APPLIED RETROACTIVELY TO GRANT REFUNDS OF INCOME TAXES PAID ON RETIREMENT INCOME BY FEDERAL RETIREES AND RETIREES FROM EMPLOYMENT WITH OTHER STATES AND THEIR POLITICAL SUBDIVISIONS?

LIST OF PARTIES

The parties to this proceeding are as follows: The Petitioners are Jim C. Pledger, Director of the Arkansas Department of Finance and Administration; Tim Leathers, Arkansas Commissioner of Revenues; and Jimmie Lou Fisher, the State Treasurer of Arkansas. The Respondents, all residents and taxpayers of Arkansas, are Stanley Bosnick, a retired employee of the United States Postal Service; Willa S. Lindsey, a retired employee of the United States Agricultural Stabilization and Conservation Service; George E. Stewart, a retired employee of the United States Internal Revenue Service; Don Lane, a retired member of the United States Air Force; John Sandfort, a retired member of the United States Army; William Dawson Barlow, a retired employee of the United States Veterans Administration; and Hank Gajda, a retired employee of the Chicago, Illinois Police Department. These Respondents, in a class action lawsuit, represent all similarly situated taxpayers.

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OPINIONS DELIVERED BELOW

The opinion of the Supreme Court of Arkansas is reported at 306 Ark. 45, ___ S.W.2d ___ (1991), and is printed in its entirety at Appendix A hereto. The document entitled Findings of Fact and Conclusions of Law (Order) of the Chancery Court of Pulaski County, Arkansas, First Division, is unreported and printed in its entirety at Appendix B hereto. The Order for Certification as a Class Action of the Chancery Court of Pulaski County, Arkansas, First Division, is unreported and printed in its entirety at Appendix C hereto.

GROUNDS UPON WHICH JURISDICTION IS INVOKED

The Opinion of the Supreme Court of Arkansas was delivered on June 10, 1991 (see Appendix A). This Petition is filed within the time allowed by law. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1257(a).

CONSTITUTIONAL PROVISIONS INVOLVED

Article VI, Section 2 of the United States Constitution provides in pertinent part:

> "The constitution and the Laws of the United States which shall be made in pursuance thereof . . . shall be the supreme Law of the Land. . . ."

Amendment XIV of the United States Constitution provides in pertinent part:

> ". . . nor shall any State deprive any person of life, liberty, or property, without due process of law. . . ."

STATUTORY PROVISIONS INVOLVED

[Pertinent text is set forth in Appendix G as provided in Rule 14.1(f) of the Rules of the Supreme Court]

STATEMENT OF THE CASE

This case arises as a result of this Court's decision in *Davis v. Michigan Department of Treasury*, 489 U.S. 803, 103 L.Ed.2d 891, 109 S.Ct. 1500 (1989), which invalidated Michigan's income tax scheme concerning taxation of retirement income.

Petitioners Jim C. Pledger, Director of the Arkansas Department of Finance and Administration, and Tim Leathers, Commissioner of Revenues, were charged with the enforcement of the Arkansas Income Tax. Respondents consist of a certified class of Arkansas residents who have retired from employment with various United States civil service agencies, with the various branches of the United States Armed Services, and with other states' agencies and political subdivisions. Respondents filed suit in the Chancery Court of Pulaski County, Arkansas, First Division, against Petitioners Pledger and Leathers in their respective capacities, along with Petitioner Jimmie Lou Fisher, in her capacity as Treasurer of the State of Arkansas. Respondents contended that the provisions of Ark. Code Ann. §26-51-307 (1987), which provided a full exemption from Arkansas Income Tax for the retirement income received from the Arkansas Public Employees, Teachers, State Highway Police, and State Highway Employees Retirement Systems, while allowing an exemption for only the first $6,000.00 of Respondents' and all other retirees' retirement income, was in violation of the principles of intergovernmental tax immunity and 4 U.S.C. §111 by favoring retired employees of the State of Arkansas and local government employees over Respondents. Petitioners argued that military retirees and retirees from employment with other states and their subdivisions were not properly members of the class and, in

any event, refunds were not due to the Respondents. The Chancellor, citing this Court's decision in *Davis*, supra, agreed with Respondents' contentions, and on November 1, 1989, ordered Petitioners to refund to Respondents all such income tax collected on their retirement income since 1985, and awarding Respondents' counsel an attorney's fee from a portion of this refund. Petitioners appealed this decision to the Arkansas Supreme Court.

On November 6, 1989, the Arkansas General Assembly enacted Act 27 of 1989 (3rd Ex. Sess.), which amended Ark. Code Ann. §26-51-307, removing the full exemption for Arkansas state retirees, and applying the $6,000.00 exemption to all public and private retirees, effective for tax year 1989.

On June 10, 1991, the Arkansas Supreme Court issued a decision affirming the decision of the Chancery Court.

ARGUMENT

(REASONS FOR ALLOWANCE OF THE WRIT)

I.

A CONFLICT EXISTS BETWEEN THE DECISION OF THE ARKANSAS SUPREME COURT IN THIS CASE AND DECISIONS OF FEDERAL APPELLATE COURTS AND A STATE COURT OF LAST RESORT REGARDING THE EXTENSION OF THE DOCTRINE OF INTERGOVERNMENTAL TAX IMMUNITY AND 4 U.S.C. § 111 TO MILITARY RETIREES AND RETIREES FROM EMPLOYMENT WITH OTHER STATES AND THEIR POLITICAL SUBDIVISIONS.

The Petitioners submit that there is a real conflict between the decision of the Supreme Court of Arkansas and decisions of federal and state appellate courts regarding the extension of the doctrine of intergovernmental tax immunity and 4 U.S.C. § 111 to military retirees and retirees from employment with other states and their political subdivisions. In its decision, the Arkansas Supreme Court stated:

> In other words, the tax discriminates based upon the source of the payment, since the source of one payment is the State of Arkansas and the source of the military pay is the federal government, and the source of the pay to a retiree from the civil service of another state is that other state's government, and therefore such tax violates 4 U.S.C. § 111 and the Doctrine of Intergovernmental Tax Immunity. (P. App. A-9)

The following discussion will show that this Court should grant this Petition in order to resolve this conflict in favor of the Petitioners.

Military Retirees

As authority for its findings in this case, the Arkansas Supreme Court cited this Court's decision in *Davis v. Michigan Department of Treasury,* 489 U.S. 803, 109 S.Ct. 1500, 103 L.Ed.2d 891 (1989). (P. App. A-2) In this case, a resident of Michigan and retired federal civil servant claimed Michigan's treatment of state retirement income discriminated against federal retirees not afforded a similar treatment under Michigan law. The Michigan income tax law allowed retired employees of the state or any of its political subdivisions to deduct retirement or pension income to the extent it is included in adjusted gross income. A similar deduction was allowed for retired employees of another state or its political subdivisions on a reciprocal basis. Taxpayers receiving retirement or pension income from any other retirement or pension systems, including the federal retirement system, could deduct up to $7,500 on a single return and up to $10,000 on a joint return.

This Court held that Michigan's tax scheme violated principles of intergovernmental tax immunity by favoring retired state and local government employees over retired federal employees. However, *Davis* does not adequately address the differences between its Plaintiff, a retired federal civil servant, and military retirees. *Davis* held that to violate 4 U.S.C. § 111, the tax must discriminate against the employee because of the *source* of the pay or compensation. This is consistent with the language of 4 U.S.C. § 111 and principles of intergovernmental tax immunity. *Davis,* supra, 109 S.Ct. at 1504-1506.

The differing tax treatment of state retirees and the federal military retirees is justified by the differing *nature* of the compensation. State retirees receive retirement benefits,

which are deferred compensation for past services. However, military retirees receive reduced pay for reduced current services as a matter of law. Such pay is subject to income tax as is all current pay for current services, including the salaries of state employees.

Military retirement pay is actually not a pension or deferred compensation, but constitutes reduced pay for reduced service. *Cornetta v. United States*, 851 F.2d 1372 (Fed. Cir. 1988); *McCarty v. McCarty*, 453 U.S. 210, 221-222, 69 L.Ed.2d 589, 599, 101 S.Ct. 2728 (1981); *United States v. Tyler*, 105 U.S. 244 (1881).

In *United States v. Tafoya*, 803 F.2d 140, 142 (5th Cir. 1986), the Court sustained the view of the defendant that his retired pay was not subject to garnishment without specific statutory authority, since it was not really "retirement pay," but "current pay."

In *Hooper v. United States*, 326 F.2d 982 (Ct. Cl. 1964), a retired Admiral was tried under the Uniform Code of Military Justice for conduct at a private residence, resulting in dismissal from the service and forfeiture of his retired pay. Plaintiff contended that Art. 2(4) of the Uniform Code of Military Justice which applied the U.C.M.J. to retired military, was unconstitutional. The Court rejected this argument, citing *Tyler:*

> . . .[W]e hold that the exercise of jurisdiction by the military tribunal over this Plaintiff was constitutionally valid, since we believe that this Plaintiff was part of the land or naval forces. We say this because the salary he received was not solely recompense for past services, but a means devised by congress to assure his availability and preparedness in future contingencies. (326 F.2d at 987)

The federal district Court dismissed Admiral Hooper's claim in *Hooper v. Hartman*, 163 F. Supp. 437 (D.C. Cal. 1958):

> Retired officers of the regular components of the Armed Forces of the United States, entitled to receive pay, are officers of the United States, and the pay is not a pension or annuity, but is an emolument of and dependent upon the office so held.
>
> Upon ceasing to hold the office, the right to pay, being an emolument thereof and dependent thereon, likewise ceases.

(163 F.Supp. at 441) (citations omitted).

The facts showed that Admiral Hooper had retired after twenty years of active duty, which points out another significant difference between retired military and civil service retirees. The system allows "retirement" before the age of 40. Therefore, it naturally follows that many military "retirees" will obtain jobs or open a business upon military retirement, since they may have 25 or more years left before they actually retire. This difference alone justifies different taxation under *Davis* since it is based on a significant difference between classes of retirees, not the source of the benefit.

In a garnishment case, the federal district court has held that retired pay is remuneration for employment, and subject to garnishment the same as active duty pay. *Watson v. Watson*, 424 F. Supp. 866, 868 (E.D.N.C. 1976). In reaching this conclusion, the Court pointed out that (1) Retired officers are subject to reduction in pay if they receive other employment (5 U.S.C. § 5532); (2) Retired pay is subject to

forfeiture on conviction of certain crimes (5 U.S.C. § 8312); (3) Retired officers are restricted from working for private defense firms within 3 years after retirement from the Armed Services (37 U.S.C. § 801); and (4) The United States Constitution prevents retired officers from working for a foreign government. (Art. 1, Sec. 9, Clause 8). *Watson, supra,* 424 F. Supp. at 869.

Chambers v. Russell, 192 F. Supp. 425 (N.D. Cal. 1961) involved facts similar to the *Hooper* case, *supra.* In reaching a similar result, the Court pointed out some additional factors that indicated that retired pay is not a pension, but compensation for present duties: (1) A retired officer may wear his uniform on appropriate occasions (10 U.S.C. § 772); (2) He may obtain medical treatment for the family at armed forces medical facilities (10 U.S.C. § 1074, 1076); (3) He is subject to the Uniform Code of Military Justice [10 U.S.C. § 802 (4)]; and (4) He may be recalled to active duty (formerly 10 U.S.C. § 6481, now 10 U.S.C. § 688). Military regulations issued by the Secretary of the various branches to implement a recall to active duty of retired personnel state retirees may be ordered to active duty *at any time.* Air Force Regulation 35-7, § 2-10 (1 Oct. 87).

The Court reiterated the historical rule in reaching its conclusion that ". . . Their commissions are not expired, but are merely dormant, pending call." *Chambers, supra,* 192 F. Supp. at 428.

Davis, supra, 109 S.Ct. at 1504, found that federal civil service retirement benefits were "deferred compensation" and that the tax on such benefits discriminated on the basis of the source of the funds. Military retirement pay is not deferred compensation, but reduced pay for reduced duty. The taxation

of such pay is based on the fundamentally different nature of military retired pay, which is not prohibited by *Davis*.

There is another reason that justified a different tax treatment of retirement income of retired members of the military. In *Davis*, (103 L.Ed.2d, at 905) this Court, citing *Phillips Chemical Co. v. Dumas Independent School District*, 361 U.S., at 383, 4 L.Ed.2d 384, 80 S.Ct. 474, restated the test to be utilized in determining whether the tax treatment is improper as ". . . the relevant inquiry is whether the inconsistent tax treatment is directly related to and justified by 'significant differences between the two classes'." (103 L.Ed.2d, at 905)

Applying this test to the military retirees, the tax treatment of this group was related to prior treatment of military income while on active duty, justifying a different treatment of military retirement income.

Under Ark. Code Ann. § 26-51-306 (1987), active duty members of the Army, Navy, Marine Corps, Coast Guard, Air Force or members drawing military pay as Reservist or National Guard, were exempt from Arkansas income tax on the first $6,000 of military income. For these persons, 20 years of Federal service toward which retirement is computed can equal at least $120,000 in exempted income for Arkansas income tax purposes. For those who stay longer in Federal service, the exemption for a member of the armed services is obviously greater.

In *Davis*, (103 L.Ed.2d, at 899) this Court was confronted with a homogenous class of federal retirees consisting only of those individuals drawing retirement benefits under the Civil Service Retirement Act, 5 U.S.C. § 8331 et seq. *Davis* did not rule with regard to the differing tax treatment of retired

employees of the military or of other states and political subdivisions thereof. The Chancellor, by his certification of the class, brought before the Court a diverse group including other states' governmental retirees and military retirees drawing a military pension under 10 U.S.C. § 1461 et seq. Each subgroup within the class must be compared separately to the class of state retirees. Unlike Paul S. Davis, who as a Michigan resident, paid taxes on income as he earned it, this case must address whether the exclusion of prior income during which a retirement was being earned and thereby being granted an economic benefit would justify different treatment of that group's retirement income relative to other retirement pensions. Certainly, retired military members gained a significant economic advantage during the years they were earning their pension. Such economic benefit cannot be viewed as inconsequential and would constitute a basis for different treatment of this group.

Applying the test to whether military retirees should be treated differently than state retirees, the answer must be in the affirmative. First, the tax treatment of the two classes of military and state retirees while inconsistent is permissible. The inconsistent tax treatment is directly related to the economic benefit conferred upon them by exempting income while earning their pension. Second, state employees while earning their pension were never exempted on any part of their income, thereby shouldering the burden of taxation only more lightly borne by those on active military service. Consequently, there exists justification to afford state retirees more favorable treatment by exempting retirement income while only partially exempting military retirement income.

In its decision, the Arkansas Supreme Court stated:

> We disagree with the appellants' argument that military pay is reduced pay for reduced service, and believe that

> those cases which held that military pay is actually deferred compensation or in the nature of a pension represent the better reasoned application law. See *Young v. Young*, 288 Ark. 33, 701 S.W.2d 369 (1986); *Askins v. Askins*, 288 Ark. 333, 704 S.W.2d 632 (1986), *Womack v. Womack*, 16 Ark. App. 108, 697 S.W.2d 930 (1985). (P. App. A-9)

The *Young*, *Askins* and *Womack* cases, which deal with the disposition of marital property, are not helpful in resolving this question because they do not consider Petitioners' full arguments on the issue.

This decision of the Arkansas Supreme Court with regard to military retirees is in direct conflict with a recent decision of the Kansas Supreme Court, *Barker v. Kansas*, 60 U.S.L.W. 2072 (decided July 12, 1991). In this case, the Kansas Supreme Court was also called on to decide the issue of whether the inconsistent tax treatment between federal military retirement benefits and state and local benefits violated the doctrine of intergovernmental tax immunity. The Kansas Supreme Court held that there was no violation, adopting the reasoning that military retirement pay is in fact current compensation for reduced, but currently rendered services, and noting the differences in funding of the military retirement system and state and local retirement systems. The Kansas Supreme Court also distinguished the marital property issue.

Other States' Retirees

The Supreme Court of Arkansas has also extended the doctrine of intergovernmental tax immunity to retirees from employment with other states and their political subdivisions.

First, it is clear that 4 U.S.C. § 111 does not provide any authority for such an extension. This section sets out that the *United States* consents to taxation of pay or compensation for personal service as an officer or employee of the United States by another taxing authority if the taxation does not discriminate because of the source of the compensation. Clearly, there is no mention of prohibited tax treatment between one state and another.

Neither does the constitutional doctrine of intergovernmental tax immunity, on which 4 U.S.C. § 111 is based, lend itself to extending the doctrine to other states' retirees. This doctrine has historically only been applied to situations where there has been differential tax treatment by the state or federal government of the other's employees. In *Davis*, supra, this Court examined this doctrine in conjunction with the establishment of 4 U.S.C. § 111 and stated:

> Hence, we conclude that the retention of immunity in § 111 is coextensive with the prohibition against discriminatory taxes embodied in the modern constitutional doctrine of intergovernmental tax immunity. Cf. *Memphis Bank & Trust*, supra, at 396-397, 74 L.Ed.2d 562, 103 S.Ct. 692 (construing 31 U.S.C. § 742 [31 U.S.C.S. § 742], which permits only "nondiscriminatory" state taxation of interest on federal obligations, as "principally a restatement of the constitutional rule"). (103 L.Ed.2d at 903-904)

In its extension of this doctrine to other states' retirees, the Supreme Court of Arkansas cited no direct authority for the proposition of such extension, nor does this Court's examination of the doctrine provide such authority. On the contrary, this doctrine has only been applied to the state or

federal government's tax treatment of the other's employees. Therefore, such an extension presents another conflict between the state court and federal decisions that justifies the granting of this Petition.

II.

A CONFLICT EXISTS BETWEEN THE SUPREME COURT OF ARKANSAS AND OTHER STATE COURTS OF LAST RESORT AS TO WHETHER THIS COURT'S DECISION IN DAVIS V. MICHIGAN DEPARTMENT OF TREASURY, 489 U.S. 803 (1989) SHOULD BE APPLIED RETROACTIVELY OR PROSPECTIVELY.

In this case, the Supreme Court of Arkansas held that the members of the certified class were entitled to refunds of Arkansas income tax collected on their pensions or retirement income. In other words, the Arkansas Court held that the case of *Davis v. Michigan Dept. of Treasury,* 489 U.S. 803 (1989) should be applied retroactively. To reach this conclusion, the Court considered the three-factor test established by this Court in *Chevron Oil Co. v. Huson,* 404 U.S. 97, 30 L.Ed.2d 296, 92 S.Ct. 349 (1971). These factors are:

> (1) to be applied nonretroactively, a judicial decision must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, or by deciding an issue of first impression whose resolution was not clearly foreshadowed;
>
> (2) in determining whether a decision should be given nonretroactive application, the Court must weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and

whether retrospective operation will further or retard its operation;

(3) where a decision of the court could produce substantial inequitable results if applied retroactively, there is ample basis for avoiding the injustice or hardship by a holding of nonretroactivity. (30 L.Ed.2d at 306)

First, the Arkansas Supreme Court held that *Davis* did not establish a new principle of law. As to the second *Chevron* factor, the Court stated that a refusal to apply the intergovernmental tax immunity doctrine in this case "may retard the recognition of it in other matters which come before the Arkansas legislature which might fall under the scope of the doctrine." (P. App. A-12) Finally, as to the third *Chevron* factor, the Court held that any inequitable results which might fall upon the State of Arkansas as a result of retroactive application did not justify a refusal to make such an application.

The Petitioners respectfully submit that the Arkansas Supreme Court misapplied the *Chevron* test, and that the *Davis* case should be given prospective application. In fact, this application by the Arkansas Supreme Court is in direct conflict with the application of *Chevron* by the South Carolina Supreme Court in *Bass v. South Carolina,* 395 S.E.2d 171 (1990); by the Virginia Supreme Court in the companion cases of *Harper v. Virginia Dept. of Taxation* and *Lewy v. Virginia Dept. of Taxation,* 401 S.E.2d 868 (1991); and by the North Carolina Supreme Court in *Swanson, et al. v. North Carolina, et al.,* Docket No. 64PA91-Wake (August 14, 1991). In these cases, the Supreme Courts of South Carolina, Virginia, and North Carolina denied refunds to federal pensioners in lawsuits similar to the present case filed in

Arkansas, holding that an analysis under *Chevron* should be read to apply the ruling in *Davis* prospectively. It is clear that the Arkansas Supreme Court was aware of this conflict, because it made the following reference to the *Harper* case:

> The Supreme Court of Virginia has held that *Davis* need not be applied retroactively. See *Harper v. Virginia Dept. of Taxation*, 401 S.E.2d 868 (Va. 1991). The Virginia Court looked to *American Trucking Associations, Inc. v. Smith*, ___ U.S. ___ , 110 S.Ct. 2323, 110 L.Ed.2d 148, 58 U.S.L.W. 4704 (1990), and determined that the *Chevron* test must be used. After an analysis of *Chevron* the Virginia Court held that retroactivity was not necessary. We respectfully disagree with that holding. (P. App. A-10, 11)

A more detailed examination of the *Chevron* factors shows that the prospective application of *Davis* by the Supreme Courts of South Carolina and Virginia provide the more proper reading of *Chevron*.

As to the first *Chevron* factor, it is clear that *Davis* established a new principle of law. That the result in *Davis* was not clearly foreshadowed is an understatement, as evidenced by the following quote from the Virginia Supreme Court in *Harper:*

> When *Davis* was decided, 23 states had statutes similar to the Michigan statute. Virginia's statute had been in effect for almost half a century. *See* Acts 1942, c. 325. As far as the record shows, the federal pensioners had paid the tax without protest. Not a single federal pensioner had brought an action during that period in a Virginia court seeking a refund of taxes on the basis of the intergovernmental tax immunity doctrine. (401 S.E.2d at 871)

Similarly, although the disparate treatment between federal and state retirees existed in Arkansas prior to the decision in *Davis,* no similar lawsuit was filed in Arkansas until after *Davis* was decided. In fact, the Arkansas Supreme Court upheld the Arkansas income tax on retirement income in the case of *Streight v. Ragland,* 280 Ark. 206, 655 S.W.2d 459 (1983). In this case, private retired taxpayers brought an action challenging the constitutionality of state income tax exemptions on retirement income of state and federal pensioners. The law provided a full exemption for some Arkansas state government retired employees, and an exemption on the first $6,000.00 of retirement income of other Arkansas state government retirees and federal retirees, while providing no similar exemptions for private retirees. The Arkansas Supreme Court held that this classification scheme did not violate equal protection clauses of the State or Federal Constitutions. The ruling in *Streight* has not been successfully challenged to this date. The restructuring of the Arkansas income tax provisions in 1985 to more equalize treatment of public and private retirees went beyond the treatment mandated by *Streight,* evidencing an alignment with clear past precedent by the Arkansas General Assembly.

The Virginia Supreme Court in *Harper* also recognized that the intergovernmental tax immunity doctrine was used prior to *Davis* to invalidate tax statutes on the proposition that these taxes had a foreseeable and direct effect on some operation of the federal government. Noting the new ground broken by *Davis,* the Court stated:

> In the present case, therefore, it is difficult to discern how the General Assembly of Virginia should have been expected to perceive that a statutory scheme, exempting state pensioners from state taxation, would have placed any foreseeable and direct burden on some federal operation. (401 S.E.2d at 872)

Neither should the Arkansas General Assembly have been expected to perceive such a ruling. Clearly, the *Davis* case established a new principle of law.

With regard to the second *Chevron* factor, it must be determined whether the intergovernmental tax immunity doctrine will be retarded or furthered by retroactive application of *Davis*. As recognized in *Harper*, the purpose of intergovernmental tax immunity is not to prevent legitimate state taxation [401 S.E.2d at 872, citing *American Trucking Assns., Inc. v. Smith*, 110 S.Ct. 2323 (1990), at 2332]. Until the ruling in *Davis*, the Arkansas statute was presumed to be a legitimate exercise of legislative taxing authority. However, the Arkansas General Assembly acted promptly after the ruling in *Davis* and the filing of this lawsuit to enact Act 27 of 1989 (3rd Ex. Sess.), which equalized tax treatment of *all* retirees. The doctrine of intergovernmental tax immunity has thus been fully served, and retroactive application of *Davis* would not further operation of the doctrine.

As to the third *Chevron* factor, Petitioners presented evidence at trial showing that a retroactive application of *Davis* would create difficult hardships for the State of Arkansas, its political subdivisions and taxpayers. For example, it has been estimated that the State of Arkansas collected approximately $7.7 million per year in income taxes on the retirement income of retired federal employees (P. App. B-6). Therefore, if refunds were ultimately ordered in this case, the State would be responsible for the payment of over $30 million to these retirees alone. In addition, the State has only recently begun to compile data on the amounts of retirement income reported as taxable income by retirees from employment with other states and their political subdivisions (P. App. B-7). This could result in a considerable

increase in the potential refund to be issued. The State presented evidence at trial that fifty percent of net available revenues goes toward public education, so the effect of such a refund on the State would be tremendous (P. App. E-2). In addition, the State presented evidence of the need for increased staffing to process such refunds to avoid a severe backlog due to the sheer number of such refund claims (P. App. F-1).

This Court, recognizing the reality of such hardships, has often held civil legislation unconstitutional, yet given only prospective effect to its holdings in order to avoid imposing undue administrative or financial burdens on agencies or local governments. See, e.g., *Lemon v. Kurtzman*, 411 U.S. 192, 36 L.Ed.2d 151, 93 S.Ct. 1463 (1973); *Cipriano v. City of Houma*, 395 U.S. 701, 23 L.Ed.2d 647, 89 S.Ct. 1897 (1969); cf. *Great Northern Railway Co. v. Sunburst Oil Refinery Co.*, 287 U.S. 358, 77 L.Ed. 360, 53 S.Ct. 145 (1932). The Courts in *Bass*, *Harper*, and *Lewy* have recognized such hardships, and have thus ruled the third *Chevron* factor satisfied.

This Court, on June 28, 1991, granted petitions for Writ of Certiorari in the *Bass*, *Harper*, and *Lewy* cases, vacating the judgments and remanding the cases to the State Supreme Courts for further consideration in light of *James B. Beam Distilling Co. v. Georgia* (Docket No. 89-680, 59 U.S.L.W. 4735). However, this Court did not reverse these cases on the merits, and an examination of *Beam* leads to the conclusion that the South Carolina and Virginia cases should be upheld.

In *Beam*, a challenge was made to a Georgia statute imposing an excise tax on imported liquor at a rate double that imposed on liquor manufactured from Georgia-grown products. This statute was similar to a Hawaii statute struck

down by this Court in *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984). The Hawaii statute was held to have violated the Commerce Clause of the U.S. Constitution. The Georgia Supreme Court affirmed the lower court decision ruling the tax unconstitutional, but applying the decision only prospectively under *Chevron*. This Court, in a plurality decision, reversed that judgment, holding that the *Bacchus* rule should be applied retroactively in the Georgia case.

The *Beam* case resulted in the issuance of five opinions from this Court. Basically, Justices Souter, Stevens and White found that *Bacchus* should be applied retroactively because the rule of the decision was applied to the litigants at bar and should, therefore, also be applied to other similarly situated parties. Justices Scalia, Blackmun and Marshall found that *Bacchus* should be applied retroactively because the U.S. Constitution does not permit prospective application of a decision of the Court. However, Justice O'Connor, Justice Kennedy and Chief Justice Rehnquist dissented from the plurality opinion, finding that a *Chevron* analysis called for a prospective application of *Bacchus*.

The *Beam* case is readily distinguishable from *Bass*, *Harper*, *Lewy*, and the present case. As previously stated, in *Beam*, Justice Souter basically found that *Bacchus* should be applied retroactively because the decision was applied to the litigants at bar and should, therefore, also be applied to other similarly situated parties. He stated:

> Once retroactive application is chosen for any assertedly new rule, it is chosen for all others who might seek its prospective application. The applicability of rules of law are not to be switched on and off according to individual hardship; allowing relitigation of choice-of-law issues

> would only compound the challenge to the stabilizing purpose of precedent posed in the first instance by the very development of "new" rules. Of course, the generalized enquiry permits litigants to assert, and the courts to consider, the equitable and reliance interests of parties absent but similarly situated. Conversely, nothing we say here precludes consideration of individual equities when deciding remedial issues in particular cases. (50 U.S.L.W. at 4739)

Therefore, it appears that, according to this view, if the Court does not rule on whether its decision applies prospectively or retroactively at the time the decision is announced, but the rule of the decision is applied to the litigants at bar, it should be assumed by the Court's silence that the decision should be applied retroactively to litigants in other cases. However, this Court's treatment of the retroactivity issue in *Davis* cannot be viewed under this rule.

In *Davis*, this Court recognized that the state of Michigan *conceded* that a refund would be appropriate if its statute were found to be unconstitutional. (103 L.Ed.2d at 906) This concession was made because Michigan's tax code contained a provision allowing a refund for taxpayers for taxes paid under a statute later found to be unconstitutional. Thus, this Court did not apply *Davis* retroactively to its litigants; it simply allowed state law to govern the issue. Even the Arkansas Supreme Court noted this distinguishing feature of *Davis* when it stated:

> The issue here is whether we are to apply retroactively our finding that the Arkansas tax is unconstitutional. *Davis* is of no value here since there the state of Michigan admitted that under their laws a refund was due. (P. App. A-10)

Unlike Michigan, Arkansas has no specific statute providing for a refund in the case a state tax statute is found to be unconstitutional. Therefore, this Court's decision in the *Beam* case should not be read to prohibit a prospective application of *Davis*.

In *Swanson*, supra, the Supreme Court of North Carolina had the opportunity to examine its case in light of this Court's decision in *Beam*, supra. The Court stated:

> This case is distinguishable from *Beam* in that the Court in *Davis* did not pass on the question of retroactivity. Michigan conceded that a refund was appropriate and the United States Supreme Court was not faced with the question of the retroactivity of the rule. In order for a case to be precedent for another case the court in the first case must pass on the issue presented in the second case. *United States v. L. A. Tucker Truck Lines, Inc.*, 344 U.S. 33, 97 L.Ed. 54 (1952); *United States v. Mitchell*, 271 U.S. 9, 70 L.Ed. 799 (1926). The question of retroactivity was not determined in *Davis* and it may be determined in this case.
>
> *American Trucking* dealt with the constitutionality of taxes imposed on trucks by the State of Arkansas. In a plurality opinion the United States Supreme Court held that pursuant to the rule of *Chevron, American Trucking Assns. v. Scheiner*, 483 U.S. 266, 97 L.Ed.2d 226 (1987), which held unconstitutional a similar tax by the State of Pennsylvania should not be given retroactive effect. Four justices dissented. In the dissenting opinion it was said that the Arkansas taxpayers were entitled to have the statute imposing the tax held to be unconstitutional. They said that the remedies to be granted depended on

> state law which had to comply with the United States Constitution. One justice concurred in an opinion which was not favorable to the application of the *Chevron* rule.
>
> We might conclude from *American Trucking* that a majority of the Supreme Court is moving away from the nonretroactive application of constitutional decisions. We do not believe we should so conclude. In *Beam* the Court had an opportunity to say that the rule of *Chevron* should no longer be applied in civil cases and declined to do so. We do not believe we should anticipate a change in the law by the United States Supreme Court, but should adhere to the opinions as they are now written. We believe we have done so.
>
> We are aware that the United States Supreme Court has vacated the judgments in the Virginia and South Carolina cases of *Harper* and *Bass* and remanded for further consideration in light of *Beam*. We believe *Beam* is clearly distinguishable from this case.

(N.C. Sup. Ct. No. 64PA91-Wake, p. 12-13)

It is abundantly clear that the decision of the Arkansas Supreme Court with regard to the application of *Davis v. Michigan Department of Treasury* decides federal questions in a way that conflicts with the decisions of state courts of last resort and federal appellate courts. Therefore, it is imperative that this Court grant this Petition so that a clear resolution of the conflict can be made.

CONCLUSION

For the foregoing reasons, certiorari should issue to the Supreme Court of Arkansas so that this honorable Court may review and correct the decision below.

Respectfully submitted,

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APPENDIX A

SUPREME COURT OF ARKANSAS

No. 90-39

Jim C. Pledger, et al.,	★	
..... Appellants,	★	
	★	Appeal from Pulaski County
v.	★	Chancery Court, No. 89-1451,
	★	Hon. Lee A. Munson, Judge
Stanley Bosnick, et al.,	★	
..... Appellees	★	Affirmed

Filed June 10, 1991

ALLEN W. BIRD II, Special Chief Justice.

Appellants, Jim C. Pledger, Director of the Arkansas Department of Finance and Administration, and Tim Leathers, Commissioner of Revenues, were charged with the enforcement of the Arkansas Income Tax. Appellees consist of a certified class of Arkansas residents who have retired from employment with various United States civil service agencies, with the various branches of the United States Armed Services, and with other states' agencies and political subdivisions.

Appellees filed suit in the Chancery Court of Pulaski County, Arkansas, against appellants Pledger and Leathers in their respective capacities, along with Jimmie Lou Fisher, in her capacity as Treasurer of the State of Arkansas. Appellees contended that the provisions of Ark. Code Ann. § 26-51-307 (1987), which provided a full exemption from Arkansas Income Tax for the retirement income received by retirees from the Arkansas Public Employees, Teachers, State Highway Police, and State Highway Employees Retirement Systems, while allowing an exemption for only the first $6,000 of appellees' and all other retirees' retirement income,

was in violation of the principles of intergovernmental tax immunity by favoring retired employees of the State of Arkansas and local government employees over retired federal employees and retired employees of other states and political subdivisions thereof. The Chancellor, citing the United States Supreme Court case of *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803 (1989), agreed with appellees' contention, and on November 1, 1989, ordered the appellants to refund to all members of the class all such income tax collected on their retirement income since 1985 and awarded appellees' counsel an attorney's fee from a portion of this refund. From this decision and decree entered by the Chancellor appellants have perfected this appeal. We affirm the lower court.

Initially we must determine whether the appeal herein is final for the purposes of Rule 2 of the Arkansas Rules of Appellate Procedure. Neither the appellants nor the appellees have raised this issue; however, we addressed the issue during oral argument of the case. Even though the parties to an appeal do not raise the issue of the appealability of an order, it is the duty of this court to do so, as a determination that the order appealed from is not final would deprive this court of jurisdiction to hear the appeal. *Associates Fin. Serv. Co. of Okla., Inc. v. Crawford County Memorial Hosp., Inc.*, 297 Ark. 14, 759 S.W.2d 210 (1988). The existence of a final order is a jurisdictional requirement for bringing an appeal, which this court is obliged to raise even though the parties do not. *3-W Lumber Co. v. Housing Auth.*, 287 Ark. 70, 696 S.W.2d 725 (1985); *John Cheeseman Trucking Inc. v. Dougan*, 305 Ark. 49, 805 S.W.2d 69 (1991).

The Arkansas Rules of Appellate Procedure state at Rule 2:

(a) An appeal may be taken from a circuit,

chancery, or probate court to the Arkansas Supreme Court from:

1. A final judgment or decree entered by the trial court; . . .

9. An order certifying a case as a class action in accordance with ARCP Rule 23. . . .

This action was filed as a class action, and the complaint and its amendments specifically prayed that a class be certified pursuant to Arkansas Rule of Civil Procedure 23. The Chancellor entered his order on August 22, 1989, finding that class certification was proper under Rule 23.

In addition, the complaint asked the lower court to: (i) find that the Arkansas Income Tax unconstitutionally discriminates against retired federal employees and retired employees of other states who receive or have received retirement benefits in excess of $6,000; (ii) enjoin the defendants from appropriating and expending any of the funds collected pursuant to a levy of the illegal income taxes and account for the amounts so collected to date; (iii) refund to the class the illegally collected income taxes, together with interest; and (iv) award reasonable attorney's fees and reimbursement of costs under Ark. Code Ann. § 26-35-902 (1987).

On November 1, 1990, the Chancellor entered his order and (i) found that the Arkansas income tax laws violated the principles of intergovernmental tax immunity and 4 U.S.C. § 111; (ii) enjoined the defendants from collecting the income tax found to be unconstitutional; (iii) ordered an accounting for and refund of the income taxes to all taxpayers represented by the class to the extent such taxes were collected in excess of the lawful taxes as determined by the court; and (iv) stated an intention to allow a reasonable part of the taxes to be refunded as attorney's fees.

The class certification order entered on August 22, 1989, was an appealable order pursuant to Arkansas Rule of Appellate Procedure 2(a)(9). *International Union of Elec., Radio and Mach. Workers v. Hudson*, 295 Ark. 107, 747 S.W.2d 81 (1988). Although the appellees have not raised the issue of timeliness of appeal of the class certification issue, timeliness of the appeal is also jurisdictional for this court. *LaRue v. LaRue*, 268 Ark. 86, 593 S.W.2d 185 (1980). However, whether the appellants failed to appeal that order in a timely manner is moot because we affirm for the reasons set forth below. The remaining issue on appealability is whether the balance of the appeal is properly before this court as a final order.

The test of finality and appealability of an order is whether the order puts the court's directive into execution, ending the litigation or a separable branch of it. *Mueller v. Killam*, 295 Ark. 270, 748 S.W.2d 141 (1988). We have often held that in order for an order to be appealable it must be such a final determination of the issues as may be enforced by some appropriate manner. *Estate of Hastings v. Planters and Stockmen Bank*, 296 Ark. 409, 757 S.W.2d 546 (1988); *Cigna Ins. Co. v. Brisson*, 294 Ark. 504, 744 S.W.2d 716 (1988). The members of the class, in the court below, asked for relief common to the class, including a declaration that certain provisions of the income tax laws of the state are unconstitutional, an injunction against using the funds illegally collected, a refund to the class, and attorney's fees for the attorney. The order of the Chancellor granted the prayer in favor of the members of the class on all of those issues. There appears to be no question that the Chancellor's rulings are final as to those issues which are common to the class. The only real issue as to appealability before this Court is whether the final rulings on those issues are rendered nonappealable when coupled with the ruling awarding attorney's fees in an unliquidated amount, and a requirement that the appellants

submit a plan for providing notice to the class of their rights to a refund and establishing the procedures for such refunds.

We view the action left to be taken after the entry of the order appealed from, relating to notice to the members of the class (1) to be remote and collateral to the main issues before the court, (2) to require an examination of factors beyond the issues needed to be decided with the merits of the original complaint, and (3) to be a largely ministerial task similar to assessing the traditional items of cost. Collateral action, such as this, is action that does not make any direct step toward final disposition of the merits of a case, will not be merged in the final judgment, is not an ingredient of the cause of action, and does not require consideration with the main cause of action. Such collateral and ministerial orders need not be final for purposes of Arkansas Rule of Civil Procedure 54 nor Arkansas Rule of Appellate Procedure 2. In *Farm Bureau Mutual Ins. Co. v. Southall,* 281 Ark. 141, 661 S.W.2d 383 (1983) we were faced with a property insurer who was faced with a second action based upon a policy. The insurer had confessed judgment and tendered the policy limits, plus penalty and interest into the registry of the court in an action in Hot Spring County. The matter of attorney's fees was still pending in the Hot Spring County action when the insured filed a second action in Pulaski County. We said in that action, "The only part of the Hot Spring County case still pending is that of determining the amount of the attorney's fees to be assessed against [the insurer]. For all practical purposes the original action is not pending." 281 Ark. at 145, 662 S.W.2d at 386.

The same is true in the case at bar. The order appealed from in this matter otherwise terminates the action as it was requested by the moving parties in the complaint on the issue of the constitutionality of the tax, the injunction and the refund. We view the matter of the details of notice and

attorney's fees to be primarily collateral and ministerial and in furtherance of the enforcement of the court's decision. It is not required under our interpretation of Rule 2 that such collateral ministerial matters be final. The order appealed from granted all the relief prayed for in the complaint and was thus final. *See Terket v. Lund*, 623 F.2d 29 (7th Cir. 1980).

Upon questioning during oral argument, counsel for the appellees was asked whether he was seeking additional attorney's fees for which additional orders of the chancery court might be necessary. Counsel indicated that he reserved his rights to seek fees pursuant to 48 U.S.C. §§ 1986 and 1988. Does such a stated intention prevent the order from which appeal is taken from being final for the purposes of Rule 2? We think not. Such actions under 48 U.S.C. §§ 1986 and 1988 may in some cases even be by separate action. *See Johnson v. Snyder*, 639 F.2d 316 (6th Cir. 1981). Such a claim for attorney's fees raises a collateral and independent claim for determination by the lower court, and thus a judgment on the merits on the other issues raised in the complaint is final as to the relief prayed of that court. *See Obin v. Dist. No. 9 of the Int'l Ass'n of Machinists and Aerospace Workers*, 651 F.2d 574 (8th Cir. 1981). It would be fruitless, and, under our interpretation of the rule, we are not required to anticipate all of the relief the parties may ask in the future when making determinations as to finality under Rule 2.

We thus hold that the lower court's order on the issues of class certification, constitutionality of the tax, the injunction, the refund and the right to attorney's fees to be final for purposes of appeal.

DID THE CHANCELLOR ERR IN INCLUDING WITH THE CERTIFIED CLASS MILITARY RETIREES AND RETIREES FROM OTHER STATES' GOVERNMENTAL AGENCIES?

For its first ground for reversal, the appellants argue that

the Chancellor erred in including within the certified class military retirees and retirees from other states' governmental agencies. In order to understand the basis for the argument by the appellees, we must consider the United States Supreme Court case upon which the appellants' case is based, *Davis v. Michigan Dept. of Treasury.*

Paul S. Davis is a former federal employee. He brought suit in Michigan seeking a refund of state taxes paid on his federal retirement benefits. He argued that the constitutional Doctrine of Intergovernmental Tax Immunity as codified at 4 U.S.C. § 111 prohibited discrimination against him, when compared with an employee retired from the employment of the State of Michigan. Section 111 allows states to tax pay or compensation for personal services as a federal officer or employee if the taxation does not discriminate against the federal employee because of the source of the pay or compensation. Michigan claimed that its laws did not violate section 111 because Mr. Davis was an "annuitant" rather than an employee and therefore section 111 did not protect him from discrimination. All of the courts in Michigan agreed with the state. *Davis v. Dep't of Treasury,* 160 Mich. App. 98, 408 N.W.2d 433 (1987).

Mr. Davis asked the Supreme Court to review the matter. The Supreme Court found that section 111 did protect Mr. Davis because section 111 protected current federal employees as well as retirees. The Supreme Court reasoned that retirement pay, though not actually disbursed during the time an individual is working, is based and computed upon the individual's salary and years of service, and was thus deferred compensation for past service. The Supreme Court reviewed the constitutional Doctrine of Intergovernmental Tax Immunity which bars those taxes that discriminate against a sovereign or those with whom it deals. In *Davis v. Michigan Department of Treasury,* the United States Supreme Court pointed out that section 111 constitutes an affirmative

statutory grant of immunity from discriminatory state taxation equal to the constitutional Doctrine of Intergovernmental Tax Immunity, which applies between the states and the federal government and among the states themselves. Thus, if we find in this case that the Arkansas tax scheme discriminates against retirees from the federal government or other states when compared to the treatment given retirees from the State of Arkansas, we must find that the tax is in violation of the Constitutional Doctrine of Intergovernmental Tax Immunity. *Phillips Chemical Co. v. Dumas Indep. School Dist.*, 361 U.S. 376.

The appellants argue that in light of our decision in *Streight v. Ragland*, 280 Ark. 206, 655 S.W.2d 459 (1983), the Arkansas statutory tax scheme is presumptively valid, which is true. However, that presumption is not conclusive. The appellees argue that *Davis* did not involve military retirees, which is also true. But again, the fact that the taxpayer in *Davis* was not a military retiree is not determinative of how this Court should rule.

The crux of this first point is whether the tax levied by the State of Arkansas discriminates against the taxpayers because of the *source* of the pay or compensation. If the source is the basis for the discrimination, then the state tax cannot withstand the Constitutional prohibition found in the Doctrine of Intergovernmental Tax Immunity which forbids such discrimination. If the discrimination is based upon the *nature* of the compensation then the Doctrine does not forbid discrimination. The appellants argue that military pay is not a pension or deferred compensation, but actually represents reduced pay for reduced service, and thus the Arkansas tax is discriminatory only as to the nature of the compensation, *i.e.*, compensation for military service rather than compensation for state civil service. We disagree with the appellants' argument that military pay is reduced pay for reduced service,

and believe that those cases which hold that military pay is actually deferred compensation or in the nature of a pension represent the better reasoned application law. *See Young v. Young*, 288 Ark. 33, 701 S.W.2d 369 (1986); *Askins v. Askins*, 288 Ark. 333, 704 S.W.2d 632 (1986), *Womack v. Womack*, 16 Ark. App. 108, 697 S.W.2d 930 (1985).

Appellants also argue that retirees from another state were not discriminated against under the Arkansas tax laws. Obviously that other state's retirees' pay is in the nature of a pension, just like the Arkansas state retirees. Thus the discrimination between the retired Arkansas civil service employee and the retiree from the civil service of another state is even more clear than in the case of the military retiree. The Arkansas tax levied upon the compensation of the military retirees and retirees from the civil service of other states is discriminatory when compared with the tax levied upon the compensation of the Arkansas civil service retirees. In other words, the tax discriminates based upon the source of the payment, since the source of one payment is the State of Arkansas and the source of the military pay is the federal government, and the source of the pay to a retiree from the civil service of another state is that other state's government, and therefore such tax violates 4 U.S.C. § 111 and the Doctrine of Intergovernmental Tax Immunity. Finally, since the retirees of the governments of other states and the military retirees are part of the same class of plaintiffs here, and are discriminated against on the same basis, they are properly in the same class. *Ross v. Arkansas Communities, Inc.*, 258 Ark. 925, 529 S.W.2d 876 (1975). The Chancellor is given wide latitude in certifying classes, and we find the certification in this case to be correct. *International Union of Elec., Radio & Mach. Workers v. Hudson.*

DID THE CHANCELLOR ERR IN AWARDING REFUNDS OF THE ARKANSAS INCOME TAX COLLECTED ON RETIREMENT INCOME OF THE CERTIFIED CLASS?

Next the appellants argue that the Chancellor erred in awarding refunds of the Arkansas income tax collected on retirement income of the certified class. The issue here is whether we are to apply retroactively our finding that the Arkansas tax is unconstitutional. *Davis* is of no value here since there the state of Michigan admitted that under their laws a refund was due. However there is other guidance. *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971) sets forth three factors which must be considered in determining the retrospective application of *Davis*. As made applicable to this case, they are first if the *Davis* decision establishes a new principle of law, either by overruling clear past precedent on which litigants have relied, or by deciding issues of first impression not clearly foreshadowed, then the decision need not be applied retroactively, otherwise it *must*. *Hanover Shoe v. United Shoe Machinery Corp.*, 392 U.S. 481. Second, this court must weigh the merits and demerits of retroactive application based upon the prior history of the doctrine, the purpose and effect and whether retroactive application will further or retard its operation. *Linkletter v. Walker*, 381 U.S. 618. Third, if the retroactive application of *Davis* produces substantial inequitable results, and such hardship may be avoided, the rule need not be applied retroactively. *Cipriano v. City of Houma*, 395 U.S. 701 (1969).

The Supreme Court of Virginia has held that *Davis* need not be applied retroactively. *See Harper v. Virginia Dept. of Taxation*, 401 S.E.2d 868 (Va. 1991). The Virginia Court looked to *American Trucking Associations, Inc. v. Smith*, ___ U.S. ___ , 110 S.Ct. 2323, 110 L.Ed. 2d 148, 58 U.S.L.W. 4704 (1990), and determined that the *Chevron* test must be used.

After an analysis of *Chevron* the Virginia court held that retroactivity was not necessary. We respectfully disagree with that holding.

The appellees argue that regardless of the three *Chevron* factors, our ruling here *must* be applied retroactively, citing *McKesson Corporation v. Division of Alcoholic Beverages and Tobacco,* 110 S.Ct. 2238 (1990), *Dep't of Business Regulation,* 110 L.Ed.2d 17 (1990), *American Trucking Associations, Inc. v. Smith,* ___ U.S. ___ ; *Ashland Oil, Inc. v. Caryl, Tax Commissioner,* ___ U.S. ___ , 110 S.Ct. 3202, 111 L.Ed.2d 734 (1990) and *National Mines Corporation v. Caryl, Tax Commissioner,* ___ U.S. ___ , 110 S.Ct. 3205, 111 L.Ed.2d 740 (1990). Under either theory, we hold that *Davis*, 489 U.S. 803, must be applied retroactively.

In support of the satisfaction of the first *Chevron* prong, the appellants argue that *Davis* and thus presumably our holding here, would be a new principle of law and a case of first impression, and therefore need not apply retroactively. We disagree. We believe that neither *Davis* nor our opinion here establishes a new principle of law. A review of the extensive historical discussion in *Davis* will clearly show that the Doctrine of Intergovernmental Tax Immunity has been applied for decades. The fact that this issue has never been before this Court, or the Supreme Court, on these facts does not make this a new principle of law or a case of first impression, just a fresh statement of the applicability of a long standing doctrine.

In support of the applicability of the second *Chevron* prong, the appellants argue that since the General Assembly immediately changed the law to comply with *Davis* retroactivity would not advance the Doctrine of Intergovernmental Tax Immunity. Again, we disagree. Obviously retroactive application will advance the doctrine for the members of this

class. Also, a refusal to apply the doctrine in this case may retard the recognition of it in other matters which come before the Arkansas legislature which might fall under the scope of the doctrine.

As to the third prong, the appellants argue that evidence presented at trial showed that the retroactive application of this decision would create hardships for the State of Arkansas, its political subdivisions, and taxpayers. No doubt the State of Arkansas will suffer financial loss by making a refund to the members of this class who follow the procedures for such refund. However, the third prong of *Chevron* requires that the decision be applied retroactively unless a substantial inequitable result will occur *as a result of the decision.* If inequitable results occur whether retroactivity is applied or not, we must make the ruling retroactive. Our decision in this case itself does not create the hardship. It will exist regardless of the outcome of this case. Clearly if the members of this class are not given the relief they have prayed for, they will be treated inequitably in that they will have paid an unconstitutional tax. Someone here will suffer, either the state or the taxpayers. We are not simply picking the class for refund based on need, nor are we penalizing the state. We are determining that since one of two inequitable results must occur, we are required to apply the ruling retroactively.

DID THE CHANCELLOR ERR IN ALLOWING REFUNDS TO MEMBERS OF THE CLASS WHO HAD NOT FILED AMENDED INCOME TAX RETURNS FOR 1985?

Next the appellants urge for reversal the proposition that the Chancellor erred in allowing refunds to members of the class who had not filed amended income tax returns for 1985. Appellants point to Ark. Code Ann. § 26-18-507 (1987) as the authority for its proposition. That statute sets forth the procedure for making a claim for a refund. The appellees

argue that requiring strict compliance with § 26-18-507 by every member of the class would ignore one of the basis for class actions suits, i.e. to deal with these types of issues in a single action rather than requiring all members of a class to bring suit. Although this court has not ruled on this precise issue as applicable to tax refunds, there is ample authority for the appellees' position and we adopt that reasoning. *See Santa Barbara Optical Co. v. State Bd. of Equalization,* 47 Cal. App.3d 244, 120 Cal. Rptr. 609 (1975); *Ware v. Idaho State Tax Commission,* 98 Idaho 477, 567 P.2d 423 (1977); *Clark v. Lee,* 273 Ind. 572, 406 N.E.2d 646 (1980); *Thorn v. Jefferson County,* 375 So.2d 780 (Ala. 1979); and *Florito v. Jones,* 39 Ill. 2d 531, 236 N.E.2d 698 (1968).

Our decision in *International Union of Elec., Radio & Mach. Workers* discusses the issues presented here as applicable to class actions generally, and we believe supports the Chancellor in his application of the rules to this class.

DID THE CHANCELLOR ERR IN AWARDING ATTORNEY'S FEES?

Finally, the appellants argue that the Chancellor erred in awarding attorney's fees in this case. This assignment of error is based upon an argument that only when the attorneys for the class establish or preserve a fund for the class are they entitled to attorney's fees. The appellants maintain that the fund here is established by the legislature as the Income Tax Refund Account for the payment of refunds to all taxpayers. The appellees maintain that the appellants have no standing to argue that attorney's fees should be awarded under the common fund doctrine, citing *Boeing Co. v. Van Gemert,* 444 U.S. 472 (1980).

An order of the Chancellor, obtained through the efforts of the attorneys for the appellees, required the Income Tax

Refund Account to be maintained at an amount not less than $8,000,000. Presumably this account would have been depleted or returned to the state treasury if not needed for other refunds if the order had not been entered. The attorneys for the class obtained the order which kept the fund at a minimum of $8,000,000 and thus we hold that the common fund was preserved by the attorneys for the class, and thus an award from that fund was proper.

Affirmed.

Holt, C.J., and Glaze and Corbin, JJ., not participating.

Dudley, Hays, and Newbern, JJ., dissent.

Special Justices Ray Baxter and Carolyn Clegg join in this opinion.

DISSENTING OPINION

DAVID NEWBERN, *Associate Justice*, dissenting. There is no final, appealable order in this case. *See* Ark. R. Ap. P. 2(a). We, therefore, lack jurisdiction to hear the appeal. *Wilburn v. Keenan Companies, Inc.*, 297 Ark. 74, 759 S.W.2d 554 (1988); *Kilgore v. Viner*, 293 Ark. 187, 736 S.W.2d 1 (1987).

The Trial Court's order establishes that the state taxes paid on retirement income received by the appellee class members were unlawfully collected and that the members are entitled, individually, to refunds for a period governed by the statute of limitations. The order then speaks of a "common fund" from which counsel representing the class will be entitled to be paid a fee. The amount of the "common fund" is undecided. We do not know how much money will be returned to the class or to any member. The amount they will receive will depend upon the amount of the attorney's fees to be paid from the fund. A dissatisfied class or class member may wish to appeal with respect to that determination once it has been made.

In *Estate of Hastings v. Planters and Stockmen Bank*, 296 Ark. 409, 757 S.W.2d 546 (1988), and in *Thomas v. McElroy*, 243 Ark. 465, 420 S.W.2d 530 (1967), we determined that an order for a money recovery which is not reduced to a specific dollars and cents amount is not a final order. We said it must be such a final determination as may be enforced by execution or in some other appropriate manner. In this case, it is obvious that neither the class nor any claimant can proceed to execute the judgment. While it may be that "some other appropriate manner" would include presentations of individual tax return claims, if indeed there is a "common fund" from which recovery is to be claimed by individuals, the amount of that fund has not been ascertained.

If the question in this case were simply the amount a party was to pay his or her attorney, having nothing to do with the recovery to be awarded ultimately to the party, I might agree with the majority's characterization of the issue as a "collateral" or "ministerial" one. The question here, however, is much more fundamental as it will determine the actual recovery to be had by the class and its individual members.

I predict there will be additional questions, such as pre-judgment and post-judgment interest, which may, along with the attorney's fee question, also give rise to questions for appeal in this matter. The reason for our finality rule is to discourage piecemeal appeals. *Wilburn v. Keenan Companies, Inc., supra; Mueller v. Killiam*, 295 Ark. 270, 748 S.W.2d 141 (1988). It should be applied in this case.

I respectfully dissent.

DUDLEY and HAYS, JJ., join in this dissent.

APPENDIX B

CHANCERY COURT OF PULASKI COUNTY, ARKANSAS
FIRST DIVISION

No. 87-2401

Stanley Bosnick and Willa S. Lindsey, George E. Stewart, Don Lane, John Sandfort, William Dawson Barlow and Hank Gajda, on behalf of Themselves and All Other Similarly Situated Taxpayers ..... *Plaintiffs*	★	
vs.	★	Findings of Fact and Conclusions of Law
Jim C. Pledger, Director of the Arkansas Department of Finance and Administration; Tim Leathers, Commissioner of Revenues, and Jimmie Lou Fisher, Treasurer of the State of Arkansas ..... *Defendants*	★	

Filed November 1, 1989

FINDINGS OF FACT AND CONCLUSIONS OF LAW

From the pleadings, stipulations, evidence adduced at trial, and briefs of the parties, the Court being well and sufficiently advised as to the facts and law in this case makes the following Findings of Fact and Conclusions of Law:

1. The parties have executed Stipulations of Fact which were filed with the Court on May 10, 1989 and on October 9, 1989. The Court does hereby accept those facts as stipulated. The Court also incorporates into its findings of fact Defendant Jim C. Pledger's responses to Plaintiffs' Requests for Admissions and Interrogatories which were filed with the Court on October 19, 1989.

2. Defendant Jim C. Pledger is the duly appointed and acting Director of the Arkansas Department of Finance and Administration (hereinafter referred to as the "Director"). Defendant Tim Leathers is the duly appointed and acting Commissioner of Revenues for the State of Arkansas (hereinafter referred to as the "Commissioner"). Defendant Jimmie Lou Fisher is the duly elected and acting Treasurer of the State of Arkansas (hereinafter referred to as the "Treasurer").

3. Plaintiff Stanley Bosnick is a resident of Lee County, Arkansas. Mr. Bosnick retired from employment with the United States Postal Service in June of 1986 and thereafter began receiving retirement income under the Civil Service Retirement System. Mr. Bosnick filed state income tax returns (Form AR1000) with the State of Arkansas for the 1987 and 1988 calendar tax years which reported having received the following amounts of civil service retirement income:

1987 — $9,432.00
1988 — $9,829.00

Such amounts were included in Mr. Bosnick's total taxable income for each tax year to the extent his retirement income exceeded the allowable $6,000.00 exemption. Mr. Bosnick paid the Arkansas income tax as reported on such returns.

4. Plaintiff Willa S. Lindsey is a resident of Lee County, Arkansas. Ms. Lindsey retired from employment with the Agricultural Stabilization and Conservation Service in July of 1987 and thereafter began receiving retirement income under the Civil Service Retirement System. Ms. Lindsey filed state income tax returns (Form AR1000) with the State of Arkansas for the 1987 and 1988 calendar tax years which reported having received the following amounts of civil service retirement income:

1987 — $7,434.00
1988 — $8,496.00

Such amounts were included in Ms. Lindsey's total taxable income for each tax year to the extent her retirement income exceeded the allowable $6,000.00 exemption. Ms. Lindsey paid the Arkansas income tax as reported on such returns.

5. Plaintiff George E. Stewart is a resident of Pulaski County, Arkansas. Mr. Stewart retired from employment with the Internal Revenue Service in 1984 and thereafter began receiving retirement benefits under the Civil Service Retirement System. Mr. Stewart filed state income tax returns (Form AR1000) with the State of Arkansas for the 1985, 1986, 1987, and 1988 calendar tax years which reported having received the following amounts of civil service retirement income:

1985 — $30,371.00
1986 — $31,132.00
1987 — $33,552.00
1988 — $34,956.00

Such amounts were included in Mr. Stewart's total taxable income for each tax year to the extent his retirement income exceeded the allowable $6,000.00 exemption. Mr. Stewart paid the Arkansas income tax as reported on such returns.

6. Plaintiff Don Lane is a resident of Pulaski County, Arkansas. Mr. Lane retired from employment with the United States Air Force in 1965 and thereafter began receiving retirement benefits under the military retirement system. Mr. Lane filed state income tax returns (Form AR1000) with the State of Arkansas for the 1985, 1986, 1987, and 1988 calendar tax years which reported having received the following amounts of military retirement income:

1985 — $15,949.00
1986 — $15,749.00
1987 — $16,145.00
1988 — $16,815.00

Such amounts were included in Mr. Lane's total taxable

income for each tax year to the extent his retirement income exceeded the allowable $6,000.00 exemption. Mr. Lane paid the Arkansas income tax as reported on such returns.

7. Plaintiff John Sandfort is a resident of Benton County, Arkansas. Mr. Sandfort retired from employment with the United States Army in 1974 and thereafter began receiving retirement income under the military retirement system. Mr. Sandfort filed state income tax returns (Form AR1000) with the State of Arkansas for the 1985, 1986, 1987, and 1988 calendar tax years which reported having received the following amounts of military retirement income:

1985 — $ 9,612.00
1986 — $ 9,612.00
1987 — $ 9,732.00
1988 — $10,140.00

Such amounts were included in Mr. Sandfort's total taxable income for each tax year to the extent his retirement income exceeded the allowable $6,000.00 exemption. Mr. Sandfort paid the Arkansas income tax as reported on such returns.

8. Plaintiff William Dawson Barlow is a resident of Nevada County, Arkansas. Mr. Barlow retired from employment with the United States Veterans Administration in 1976 and thereafter began receiving retirement benefits under the Civil Service Retirement System. Mr. Barlow filed state income tax returns (Form AR1000) with the State of Arkansas for the 1985, 1986, 1987, and 1988 calendar tax years which reported having received the following amounts of civil service retirement income:

1985 — $18,126.00
1986 — $19,812.00
1987 — $20,064.00
1988 — $20,904.00

Such amounts were included in Mr. Barlow's total taxable income for each tax year to the extent his retirement income

exceeded the allowable $6,000.00 exemption. Mr. Barlow paid the Arkansas income tax as reported on such returns.

9. Plaintiff Hank Gajda is a resident of Baxter County, Arkansas. Mr. Gajda retired from employment with the Chicago, Illinois Police Department in 1986 and thereafter began receiving retirement benefits under a retirement plan sponsored by the City of Chicago. Mr. Gajda filed state income tax returns (Form AR1000) with the State of Arkansas for the 1986, 1987, and 1988 calendar tax years which reported having received the following amounts of retirement income:

1986 — $15,939.00
1987 — $26,127.00
1988 — $27,123.00

Such amounts were included in Mr. Gajda's total taxable income for each tax year to the extent his retirement income exceeded the allowable $6,000.00 exemption. Mr. Gajda paid the Arkansas income tax as reported on such returns.

10. Each of the Plaintiffs have filed amended income tax returns, and/or claim for refund on the form which was approved by an Order executed by the Court on April 19, 1989 seeking a refund of the income taxes paid with respect to their retirement income. Plaintiffs George E. Stewart, Don Lane, John Sandfort, and William Dawson Barlow filed amended state income tax returns for the 1985 tax year on or before May 15, 1989. Plaintiffs George E. Stewart, Don Lane, John Sandfort, and William Dawson Barlow also executed and filed a Claim for Refund on the form which was approved by the Court on April 19, 1989. The Department of Finance and Administration has notified each of the Plaintiffs in writing of its decision to refuse to refund the income taxes claimed by them on their amended income tax returns and/or the Claim for Refund Form.

11. The Department has in its possession all of the

original income tax returns and related computer records for the calendar tax year 1985 and all subsequent tax years. The Department has agreed to preserve such returns and computer records until a final decision is rendered in this case regarding the issue of whether the Plaintiff-taxpayers are entitled to tax refunds as claimed.

12. The Arkansas Department of Finance and Administration ("the Department") has determined that there are approximately 18,185 retired persons who are currently receiving retirement benefits from the Arkansas Public Employees Retirement System, the Arkansas Teacher Retirement System, the Arkansas State Police Retirement System, the Arkansas State Highway Employees Retirement System.

13. The Department has estimated that approximately $7,700,000.00 in Arkansas income taxes are collected from retired federal employees each tax year. This estimate was determined by using historical data obtained from the actual Arkansas income tax returns filed for the 1987 calendar tax year along with other pertinent data obtained by the Department from the Office of Personnel Management ("OPM") in Washington, D.C.

14. Beginning with the 1987 calendar tax year, retired military persons reported their "U.S. Armed Services Retirement Pay" separately on lines 18A and 18B of their Arkansas income tax returns (Form AR1000). The Department's records reflect that a total of $81,783,670.00 was reported by taxpayers for the 1987 calendar tax year as "U.S. Armed Services Retirement Pay" on 13,306 individual income tax returns. The Department multiplied this amount of taxable income times a 3.9% average effective tax rate for the 1987 calendar tax year to arrive at an estimated $3,189,561.00 in Arkansas income taxes which was paid with respect to such military retirement income.

15. All retirement income, other than "U.S. Armed Services Retirement Pay," is required to be reported on lines 17A and 17B of the Arkansas individual income tax return (Form AR1000). The information reported to the Department on Arkansas individual income tax returns is insufficient to enable the Department to identify the amount of retirement income which is reported by retired federal employees, except for the "U.S. Armed Services Retirement Pay" which is reported separately. The Department has obtained data from the OPM which reflects that 20,303 civil service retirees resided in Arkansas during the 1986 calendar tax year and received a total of $237,827,964.00 in civil service retirement benefits. The Department has reduced this amount by the $6,000.00 exemption amount available to each retiree under Ark. Code Ann. § 26-51-507(a) totaling $121,816,622.00 to arrive at an estimated $116,011,342.00 in taxable civil service retirement income which was received by such retired federal employees. The Department has multiplied this estimated amount of taxable income times a 3.9% average effective tax rate for the 1987 calendar tax year to arrive at an estimated $4,524,442.00 in annual Arkansas income taxes collected with respect to the civil service retirement income of such retired federal employees.

16. The Department does not have any reasonable methods available to estimate the amounts of retirement income reported as taxable income to the State of Arkansas by retirees of other states and political subdivisions of other states. Therefore, the Department has been unable to prepare any estimate of the amount of Arkansas income taxes paid by such retirees to the State of Arkansas.

17. Section 1 of Act 579 of 1989 appropriated $150 million for each fiscal year in the 1989-1991 biennium for making refunds of state income taxes and homestead property tax relief refunds. Presently, and as projected for future use,

only approximately two percent (2%) of the appropriated funds are expended for homestead property tax relief. All of the remainder, in an amount of at least $146 million per year, is for the express purpose of making refunds of income taxes. Those funds cannot be used for any other purposes. The funds are maintained and accounted for by the State Treasurer in the Office of Accounting, Department of Finance and Administration. The Department of Finance and Administration has estimated that approximately $7,700,000.00 in Arkansas income taxes are collected from retired federal employees each tax year with respect to their retirement income. The methods used by the Department in arriving at these estimates were set forth in paragraphs 2 and 3 of the Joint Stipulation of Facts executed and filed of record in this case on May 10, 1989. The Department has determined that the funds appropriated by § 1 of Act 579 of 1989 will be available and sufficient to pay refunds of such taxes plus statutory interest thereon at the rate of 10% per annum if the State is ordered by a final Court decision to refund such taxes paid with respect to the 1985, 1986, 1987, 1988, and 1989 tax years.

18. Approximately 2,200 taxpayers have filed claims for refund on the Court approved form but did not file amended income tax returns.

CONCLUSIONS OF LAW

19. In *Davis v. Michigan Dept. of Treasury*, ___ U.S. ___, 109 S.Ct. 1500, 103 L.Ed.2d 891 (1989) the Supreme Court held that Michigan's Income Tax Act violated the "principles of intergovernmental tax immunity by favoring retired state and local government employees over retired federal employees." 109 S.Ct., at 1508. Michigan had allowed retired government employees of the State of Michigan to claim an income tax deduction equal to the amount of retirement or pension benefits they received from any public retirement system created by the State of Michigan or a

political subdivision thereof. All other taxpayers were permitted to deduct an amount equal to their retirement benefits but were limited to a $7,500.00 deduction on a single income tax return and a $10,000.00 deduction on a joint income tax return.

20. Arkansas' income tax laws allow retired employees of the State of Arkansas to claim an income tax exemption equal to the full amount of retirement benefits they receive from the Arkansas Public Employees Retirement System, the Arkansas Teacher Retirement System, the Arkansas State Police Retirement System, or the Arkansas State Highway Employees Retirement System. [Ark. Code Ann. § 26-51-307(b)]. All other taxpayers are allowed to claim an exemption equal to the amount of their retirement benefits, however, the amount which may be exempted is generally limited to $6,000.00 per person. [Ark. Code Ann. § 26-51-307(a)]. Retired military personnel who received both military retirement pay and other retirement benefits prior to January 1, 1985 are permitted to claim a separate $6,000.00 exemption each year for their military retirement pay in addition to any exemption allowed by § 26-51-307 (Ark. Code Ann. § 26-51-309).

21. Arkansas' income tax laws are virtually identical to Michigan's income tax laws which were held unconstitutional in *Davis*. Michigan used tax deductions and Arkansas uses exemptions, however, the result is the same.

22. The Supreme Court's decision in *Davis* dictates that this Court reach the conclusion that Arkansas' income tax laws violate the principles of intergovernmental tax immunity by favoring retired State government employees over retired federal employees, including both civil service and military retirees.

23. The doctrine of "intergovernmental tax immunity

bar[s] those taxes that [are] imposed directly on one sovereign by the other or that discriminate . . . against a sovereign or those with whom it [has] dealt." *Davis v. Michigan Dept. of Treasury, supra,* 109 S.Ct., at 1505. The doctrine of "intergovernmental tax immunity is based on the need to protect each sovereign's governmental operations from undue interference by the other." *Davis v. Michigan Dept. of Treasury,* 109 S.Ct., at 1507; *Graves v. New York,* 306 U.S., at 481, 59 S.Ct., at 598; *McCulluch v. Maryland,* 4 Wheat, at 435-436. "[T]he imposition of a heavier tax burden on [those who deal with one sovereign] than is imposed on [those who deal with the other] must be justified by significant differences between the two classes." *Davis v. Michigan Dept. of Treasury,* 109 S.Ct., at 1508, citing *Phillips Chemical Co. v. Dumas Independent School Dist.,* 361 U.S., at 383, 80 S.Ct., at 479.

24. Separate Defendants Jim C. Pledger and Tim Leathers have made the following arguments to the effect that the Supreme Court's ruling in *Davis* does not prohibit Arkansas from taxing military retirement income differently than it taxes the retirement income which it pays to retired state government employees:

> The differing tax treatment of state retirees and the federal military retirees is justified by the differing nature of the compensation. State retirees receive retirement benefits, which are deferred compensation for past services. However, military retirees receive reduced pay for reduced current services as a matter of law. Such pay is subject to income tax as is all current pay for current services, including the salaries of state employees.
>
> Military retirement pay is actually not a pension or deferred compensation, but constitutes reduced pay for

> reduced service. *Cornetta v. United States*, 851 F.2d 1372 (Fed. Cir. 1988); *McCarty v. McCarty*, 453 U.S. 210, 221-222, 69 L.Ed.2d 589, 599 101 S.Ct. 2728 (1981) (military retired pay is reduced compensation for reduced current services); *United States v. Tyler*, 105 U.S. 244 (1881).

These arguments are inconsistent with the Arkansas Supreme Court's decisions which have held that prospective military retirement income benefits which are accrued as the result of military service performed during the term of a marriage constitute marital property. *Young v. Young*, 288 Ark. 33, 701 S.W.2d 33 (1986); *Askins v. Askins*, 288 Ark. 335, 704 S.W.2d 632 (1986). The differences between military retirement income and the retirement income paid to state retirees are not "significant differences" that would justify the State of Arkansas discriminatorily taxing the federal military retirement income.

25. The doctrine of intergovernmental tax immunity requires that States provide equal tax treatment for retired employees of all sovereignties including other States and political subdivisions thereof. The Court holds that the doctrine of intergovernmental tax immunity also prohibits the State of Arkansas from discriminatorily taxing retired employees of other States and political subdivisions thereof.

26. The Supreme Court made the following comments in *Davis*, regarding the remedy issue:

> [W]e conclude that the Michigan Income Tax Act violates principles of intergovernmental tax immunity by favoring retired state and local government employees over retired federal employees. *The State having conceded that a refund is appropriate in these circumstances, . . . to the extent appellant has paid taxes*

pursuant to this invalid tax scheme, he is entitled to a refund. See *Iowa-Des Moines Bank v. Bennett*, 284 U.S. 239, 247, 52 S.Ct. 133, 136, 76 L.Ed. 265 (1931). (emphasis added)

Appellant also seeks prospective relief from discriminatory taxation. With respect to this claim, however, we are not in the best position to ascertain the appropriate remedy. While invalidation of Michigan's income tax law in its entirety obviously would eliminate the constitutional violation, the Constitution does not require such a drastic solution. We have recognized, in cases involving invalid classifications in the distribution of government benefits, that the appropriate remedy "is a *mandate* of equal treatment, a result that can be accomplished by withdrawal of benefits from the favored class as well as by extension of benefits to the excluded class." *Heckler v. Mathews*, 465 U.S. 728, 740, 104 S.Ct. 1387, 1395, 79 L.Ed.2d 646 (1984). See *Iowa-Des Moines Bank, supra*, 284 U.S., at 247, 52 S.Ct., at 136; see also *Welsh v. United States*, 398 U.S. 333, 361, 90 S.Ct. 1792, 1807, 26 L.Ed.2d 308 (1970) (Harlan, J., concurring in judgment).

In this case, appellant's claim could be resolved either by extending the tax exemption to retired federal employees (or to all retired employees), or by eliminating the exemption for retired state and local government employees. *The latter approach, of course, could be construed as the direct imposition of a state tax, a remedy beyond the power of a federal court.* See *Moses Lake Homes, Inc. v. Grant County*, 365 U.S., at 752, 81 S.Ct., at 874 ("Federal courts may not assess or levy taxes"). The permissibility of either approach, moreover, depends in part on the severability of a portion of § 206.30(1)(f) from the remainder of the Michigan Income Tax Act, a question of state law within the special expertise of the

> Michigan courts. See *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 540-541, 53 S.Ct. 481, 486-487, 77 L.Ed. 929 (1933). It follows that the Michigan courts are in the best position to determine how to comply with the mandate of equal treatment. *Davis v. Michigan Dept. of Treasury*, 109 S.Ct. 1508-1509. (emphasis added)

On remand, the Michigan Court of Appeals held that "federal employees must receive the same tax treatment afforded state and local employees". *Davis v. Department of Treasury*, ___ N.W.2d ___, 1989 WL 98935 (Mich. App., August 21, 1989) (No. 117204). The Michigan Court of Appeals specifically decided not to eliminate (strike) the exemption for state and local employees noting that the Michigan Legislature was free to extend the income tax exemption to retired state and local employees if it so desired.

27. Declaring the exemption contained in § 26-51-307(b) invalid prospectively would result in the imposition of the State income tax on the retirement income of retired state government employees which the Arkansas Legislature has specifically expressed its intent not to tax. Such judicial action would violate the separation of powers required by Art. IV, §§ 1 and 2 of the Arkansas State Constitution by invading the exclusive province of the legislative branch of government.

28. The Court adopts the reasoning of the Michigan Court of Appeals by holding that federal retirees and employees of other states and subdivisions thereof must receive the same income tax treatment that is afforded to retired employees of the State of Arkansas under § 26-51-307(b).

29. In addition to declaratory relief, Plaintiffs seek refunds of the income taxes which they have paid with respect to their government retirement benefits. Ark. Code Ann. § 26-18-507(a) provides:

> Any taxpayer who has paid any State tax to the State of Arkansas, through error of fact, computation, or mistake of law, ***in excess of the taxes lawfully due*** shall, subject to the requirements of this chapter, be refunded the overpayment of the tax determined by the director to be erroneously paid upon the filing of an amended return or a verified claim for refund.

The taxpayers represented by this class action suit have paid income taxes to the State of Arkansas "in excess of taxes lawfully due" and are entitled to a refund of such taxes, plus interest thereon pursuant to § 26-18-508, provided that the statute of limitations contained in § 26-18-306(i) had not barred their rights to a refund prior to the filing of this suit on March 31, 1989.

30. Taxpayers are required to file individual state income tax returns for each calendar tax year on or before May 15 of the succeeding year unless they obtain an extension to file. (Ark. Code Ann. § 26-51-806). The normal statute of limitations period for any taxpayer to claim a refund of taxes reported on income tax returns for the 1985 calendar year tax and any subsequent tax years would not have expired until after May 15, 1989. Thus, the taxpayers represented by this class action suit are entitled to refunds of the income taxes they reported on individual income tax returns for the 1985 calendar tax year and any subsequent tax years.

WHEREFORE, IT IS ORDERED, ADJUDGED AND DECREED by the Court as follows:

(1) Arkansas' income tax laws violate the principles of intergovernmental tax immunity and 4 U.S.C. § 111 by favoring retired State government employees over retired federal employees and employees of other States and political subdivisions thereof.

(2) Defendant Jim C. Pledger, Director of the Arkansas Department of Finance and Administration, and Defendant Tim Leathers, Commissioner of Revenues, are hereby enjoined from collecting the Arkansas income tax with respect to the retirement income received by retired federal employees and employees of other States and political subdivisions to the extent that such taxes have been determined to be unconstitutional as set forth hereinabove.

(3) The Defendants are hereby ordered to account for and refund the income taxes to all taxpayers represented by this class action suit to the extent such taxes have been collected in excess of that lawfully due as determined hereinabove. Furthermore, the Defendants are ordered to submit to the Court within thirty (30) days a plan for providing notice to the taxpayers represented by this class action suit of their rights to a refund and establishing procedures, forms, and instructions to be used in implementing such refunds in an orderly fashion.

(4) "[W]hen a class action results in the recovery of a 'common fund' it is proper to allow attorneys' fees to be paid from the fund." *American Trucking Association v. Gray,* 295 Ark. 43, 47 (1988); *Powell v. Henry,* 267 Ark. 484 (1980); and *Marlin v. Marsh,* 189 Ark. 1157 (1934). Counsel for the Plaintiffs shall be apportioned and awarded a reasonable part of the common fund held subject to refund as compensation for professional services performed and for reimbursement of costs expended.

(5) The Court retains jurisdiction of this cause for the purpose of ascertaining and enforcing all rights and obligations of the parties under this Order, and for other proper relief.

DATED this 1st day of November, 1989.

/s/ Lee A. Munson, Chancellor

APPENDIX C

CHANCERY COURT OF PULASKI COUNTY, ARKANSAS
FIRST DIVISION

No. 87-2401

Stanley Bosnick and Willa S. Lindsey, George E. Stewart, Don Lane, John Sandfort, William Dawson Barlow and Hank Gajda, on behalf of Themselves and All Other Similarly Situated Taxpayers ..... *Plaintiffs*	★	
	★	Order for Certification
vs.	★	As a Class Action
	★	
Jim C. Pledger, Director of the Arkansas Department of Finance and Administration; Tim Leathers, Commissioner of Revenues, and Jimmie Lou Fisher, Treasurer of the State of Arkansas ..... *Defendants*	★	

Filed August 22, 1989

ORDER FOR CERTIFICATION AS A CLASS ACTION

Plaintiffs filed a Motion for Certification as a Class Action on August 21, 1989. The Defendant, Jim C. Pledger, Commissioner of Revenues, and the Defendant, Jimmie Lou Fisher, Treasurer of the State of Arkansas, filed a Response thereto and a hearing was held before the Court on August 22, 1989. From said Motion and the Defendants' Response and other things and matters before it, the Court finds and ORDERS as follows:

1. Plaintiffs filed their Complaint herein on March 31, 1989 on behalf of themselves and that class of all other taxpayers who are similarly situated seeking to enjoin the

collection of the Arkansas income tax from the Plaintiffs and all other similarly situated taxpayers, as an illegal exaction to the extent it is levied upon certain retirement and disability income; to enjoin the appropriation and expenditure of such taxes illegally exacted; and to order an accounting and a refund to Plaintiffs and all other similarly situated taxpayers of the amount of Arkansas income taxes illegally exacted and collected to date.

2. The Court's jurisdiction is founded upon Article 16, Section 13 of the Constitution of the State of Arkansas, Ark. Code Ann. § 26-18-507 and 42 U.S.C. § 1983. Illegal exaction suits such as this which challenge the legality of a tax are as a matter of law class action suits. *City of Little Rock v. Cash*, 227 Ark. 494, 511 (1982). "Every citizen is regarded as a party to the proceedings, and is bound by the judgment entered" by this Court. *Id.* at 511. "In such cases the people are regared as the real parties." *Id.* at 511.

3. The class sought to be represented by the named Plaintiffs is that class of all taxpayers who have been or will be forced to pay the Arkansas income tax with respect to retirement income or disability benefits received as compensation for services rendered as an employee of the United States Government or an agency thereof or as an employee of other states or political subdivisions and agencies of other states. This class specifically includes former military and civilian employees.

4. Certifying the above-styled cause as a class action will provide a fair and efficient method for adjudication of this controversy in a single forum in which all parties with an interest in the subject matter will have an opportunity to be heard. Further, a class action will resolve the legality and constitutionality of the income taxes in question for all of the class members at one time, and will also spare the State the

burden of having to participate in multiple lawsuits brought by or against individual taxpayers in which the same issues are raised.

5. The class of taxpayers described in paragraph 3 above includes more than 30,000 taxpayers and is so large that it is impractical to bring them all before this Court within a reasonable time. As such, the named Plaintiffs should, pursuant to Article 16, Section 13 of the Arkansas State Constitution, be allowed to sue for the benefit of all members of the class.

6. The questions of fact and law in this case are common to all members of the class described in paragraph 3 above and the questions of fact and law which are common to the members of the above-styled class predominate over any possible questions affecting only individual members of the class. As such, a class action is superior to other available methods for the fair and efficient adjudication of the issues and controversy raised by this suit.

7. The Plaintiffs that have instituted this suit represent a cross section of the various types of taxpayers who have been, and will be, subjected to the payment of the taxes in question. Their claims are typical of the claims of all members of the similarly situated class. The Plaintiffs will fairly and adequately protect the interests of the class of similarly situated taxpayers and they are ably qualified to prosecute this action to a conclusion.

8. Subject to verification of the facts set forth by the Plaintiffs in their pleadings filed with this Court, pursuant to Ark. R. Civ. Proc. 23, this suit is hereby certified as a class action suit, the named Plaintiffs are hereby certified as class representatives of the class of taxpayers described above in paragraph 3, and Plaintiffs' attorney, Carrold E. Ray is

hereby appointed as counsel for the class of taxpayers.

9. Notice of the maintenance of this action as a class action need not be given by any formal means of publication, since a cause of action brought pursuant to Article 16, Section 13 of the Arkansas State Constitution is, by its very nature, a taxpayers' "class action" suit. *City of Little Rock v. Cash*, 227 Ark. 494 (1982).

WHEREFORE, this Order for Class Certification is executed this 22nd day of August, 1989.

/s/ Lee A. Munson
Chancellor

APPENDIX D

CHANCERY COURT OF PULASKI COUNTY, ARKANSAS
FIRST DIVISION

No. 89-1451

Stanley Bosnick and Willa S. Lindsey, On Behalf of Themselves and All Other Similarly Situated Taxpayers ..... *Plaintiffs*	★	
vs.	★	Order
Jim C. Pledger, Commissioner of Revenues, and Jimmie Lou Fisher, Treasurer of the State of Arkansas ..... *Defendants*	★	

Filed May 10, 1989

ORDER

Plaintiffs have filed a Motion for Preliminary Injnction requesting that the Court order the Defendants to place the challenged Arkansas income taxes into an interest-bearing escrow account and for other relief. From the representations of counsel for Plaintiffs and Defendants, and other matters presented to the Court, the Court finds:

1. The Defendant Commissioner of Revenues maintains that the funds which are held in the Income Tax Refund Fund will be available for the purposes of satisfying any refund of income taxes which a Court might eventually order paid to the Plaintiff-taxpayers. In order to assure the Plaintiff-taxpayers of an adequate remedy at law in the form of a refund, the available funds in the Income Tax Refund Fund shall not be reduced during the pendency of this suit below the amount of estimated Arkansas income taxes paid by the Plaintiff-taxpayers.

2. The Defendants have agreed that in the event a Court ultimately orders a refund of income taxes to the Plaintiff-taxpayers they shall be entitled to receive interest on such refunds as allowed by law, or such amount of interest which would have accrued had this Court ordered the challenged income taxes to be placed into an interest-bearing escrow account on May 10, 1989, on which the parties agree that interest at the rate of eight and one half percent (8 1/2%) per annum would be earned.

3. The Court has determined that there is a likelihood that the Plaintiff-taxpayers will succeed in their efforts to challenge the legality of Arkansas income taxes which have been imposed upon their retirement income. Based upon the stipulations and verbal representations made by counsel for the Defendant, Commissioner of Revenues, the Court has determined that the Plaintiff-taxpayers will be assured of an adequate remedy at law in the form of a refund if the Defendants are ordered not to reduce the amount of funds held in the Income Tax Refund Fund below certain minimum levels and that such funds will remain available for purposes of paying a refund to the taxpayers should a Court ultimately order refunds to be made.

4. The Defendants are hereby ordered to maintain a minimum balance of funds in the Income Tax Refund Fund equal to the initial amount of $8,000,000.00. Defendant Commissioner of Revenues shall advise Plaintiffs' attorney quarterly of the funds in the Income Tax Refund Fund which remain available for refunding of income taxes. The Commissioner of Revenues shall prepare revised estimates of the amount of income taxes paid by the Plaintiff-taxpayers with respect to their federal retirement income for the 1988 calendar tax year by taking a random statistical sampling of individual income tax returns which were filed by the Plaintiff-taxpayers for the 1987 calendar tax year.

Such estimates shall be conducted in cooperation with and under the supervision of Mr. Richard Sims of the Arkansas Legislative Council who shall independently verify to the Court the methods and procedures used in arriving at such estimates. Such estimates shall be prepared on or before July 14, 1989 unless otherwise extended by the Court. In the event such revised estimates shall exceed $8,000,000, then the minimum balance of funds which the Defendants shall maintain in the Income Tax Refund Fund pursuant to this Order shall be increased to an amount equal to the revised estimate of the income taxes paid by the Plaintiff-taxpayers with respect to their federal retirement income.

5. The parties shall make every reasonable effort to expedite the preparation of this case and submit it to the Court for a decision on the constitutional issues raised by the Plaintiff-taxpayers as soon as possible. In the event a final nonappealable decision is not rendered by the end of this 1989 calendar tax year, the minimum amount which the Defendants shall be required to retain in the Income Tax Refund Fund shall be increased by an additional $8,000,000.00 or the amount of estimated income taxes determined pursuant to the provisions of paragraph four (4) above, if greater, for each additional calendar tax year which shall expire during the pendency of this case.

6. The Court hereby incorporates into this Order the joint stipulation of facts entered into on May 10, 1989 by counsel for Plaintiffs and Defendant Commissioner of Revenues.

7. The Defendant Commissioner of Revenues shall change the 1989 Individual Income Tax Return Forms (Form AR1000 and AR1000NR) to provide for the following:

1. Boxes shall be inserted on the face of the Arkansas

Income Individual Income Tax Forms AR1000 and AR1000NR to allow the Plaintiff-taxpayers to identify themselves as federal retirees or retirees of other states including political subdivisions thereof.

2. Instructions shall be added to the Individual Income Tax Booklet to explain the reasons and purposes for the boxes added to the face of forms AR1000 and AR1000NR as required above.

3. The Defendant, Commissioner of Revenues, shall maintain electronic data processing records of all Plaintiff-taxpayers who shall check the appropriate box or boxes added to forms AR1000 and AR1000NR as required hereinabove.

IT IS SO ORDERED.

Entered this 10th day of May, 1989.

/s/ Lee A. Munson
Chancellor

APPENDIX E

SUPREME COURT OF ARKANSAS

No. 90-39

Jim C. Pledger, et al.,	★	
..... Appellants,	★	
	★	Appeal from the Chancery
v.	★	Court of Pulaski County,
	★	Arkansas, First Division
Stanley Bosnick, et al.,	★	
..... Appellees.	★	

Filed April 12, 1990

PORTION OF ABSTRACT OF TESTIMONY OF JOSEPH LAFACE, FORMER RESEARCH ADMINISTRATOR FOR THE ARKANSAS DEPARTMENT OF FINANCE AND ADMINISTRATION

PROCEEDINGS OF OCTOBER 18, 1989

Before the Honorable Lee A. Munson, *Chancellor*

"This analysis, Defendants' Exhibit One, examines the effects of a potential cut of Thirty-two Million Dollars, and that figure was based on Twenty-five Million Dollars plus any additional interest rate charges that might be incurred. So, I examined simply who would bear the burden of a cut of Thirty-two Million Dollars, and as far as state spending is concerned, it's a fairly straight forward piece of analysis. Fifty percent of the general revenue, net available revenues from the State of Arkansas, go toward public education, kindergarten through twelfth grade, and the next major category is higher education, which gets approximately seventeen percent, and then we have general education fund, which I may go into a little bit of detail there, if I may. That concerns the School for the Blind and Deaf. It concerns vocational

education. Contributions to the AETN television network, and that's another three percent. So approximately seventy percent of the State's general revenue budget is allocated toward education in the State. And, to examine the impact, we simply took what the current State's contribution is per pupil in the last year, which was the fiscal year 1989, and the State currently for four hundred and fifty-eight thousand students in grades "k" through twelve in Arkansas, the State contributed One Thousand Eight Hundred and Sixty-three Dollars per each student. (TR 443-444)

In 1988, the previous year, the State's contribution per pupil amounted to One Thousand, Eight Hundred and Forty-three Dollars. So, the increase in the fiscal year '89 compared to the previous year was Twenty Dollars per pupil, or about one percent. So given these figures, the impact of a cut of Thirty-two Million Dollars on the public school fund since the schools receive fifty percent of the net available revenues, the loss to the public education fund would be Sixteen Million Dollars, or Thirty-five Dollars per pupil, and that cut would wipe the 1989 gain, and push funding levels back to what they were in fiscal year 1987. At the present time, State contributions to public education in Arkansas are increasing from year to year. I made a note in the document that in 1965 the State's share of total school expenditures was forty-eight percent. Today it is sixty-one percent." (TR 444-445) (Appellants' Abstract, pp. 111-113)

APPENDIX F

SUPREME COURT OF ARKANSAS

No. 90-39

Jim C. Pledger, et al.,	★	
..... Appellants,	★	
	★	Appeal from the Chancery
v.	★	Court of Pulaski County,
	★	Arkansas, First Division
Stanley Bosnick, et al.,	★	
..... Appellees.	★	

Filed April 12, 1990

PORTION OF ABSTRACT OF TESTIMONY OF DAVID FOSTER, MANAGER, INDIVIDUAL INCOME TAX SECTION, ARKANSAS DEPARTMENT OF FINANCE AND ADMINISTRATION

PROCEEDINGS OF OCTOBER 18, 1989

Before the Honorable Lee A. Munson, *Chancellor*

"At the present level of staffing and with the present number of returns on hand, we're looking at approximately three years probably to process these amended returns if a ruling of this Court requires us to process them. These are the twenty-eight thousand that we have on hand at this time. We reached that estimate based on the fact that we are able to process approximately eight thousand amended claims for refund each year. So if we have twenty-eight thousand, we have approximately a three and a half year backlog if we have no other documents — if we have no other amended documents to process. I'm sure that a number of these amended returns would have other basis for refund other than just a specific Bosnick versus Pledger claim. I don't think that it would be possible to process that apart from what is claimed

as a result of this case because we have an incomplete record. Those are being held also.

"I imagine that these amended returns are the first to be filed. We potentially could have — we have some forty-three thousand people included in the class times four years. So, we have a hundred and seventy thousand possibly, potentially. Based on our earlier estimates, we could see with current capabilities and staffing approximately eleven years as to the time involved as to these additional amended returns." (TR 418-419) (Appellant's Abstract, p. 100-101)

APPENDIX G

STATUTORY PROVISIONS INVOLVED

Ark. Code Ann. § 26-18-306 (1987) provides in pertinent part:

> ". . . (i) An amended return or verified claim for credit or refund of an overpayment of any state tax for which the taxpayer is required to file a return shall be filed by the taxpayer within three (3) years from the time the return was filed or two (2) years from the time the tax was paid, whichever of the periods expires the later, or as long as the statute of limitations for assessment is still open to the director."

Ark. Code Ann. § 26-18-507 (1987) provides in pertinent part:

> "(a) Any taxpayer who has paid any state tax to the State of Arkansas, through error of fact, computation, or mistake of law, in excess of the taxes lawfully due shall, subject to the requirements of this chapter, be refunded the overpayment of the tax determined by the director to be erroneously paid upon the filing of an amended return or a verified claim for refund.
>
> (b) The claim shall specify:
>
> (1) The name of the taxpayer;
> (2) The time when and the period for which the tax was paid;
> (3) The nature and kind of tax paid;
> (4) The amount of the tax which the taxpayer claimed was erroneously paid;
> (5) The grounds upon which a refund is claimed; and
> (6) Any other information relative to the payment as may be prescribed by the director. . . ."

Ark. Code Ann. § 26-51-306 (1987) provides in pertinent part:

> "(a)(1) No member of the armed services of the United States shall be liable for or required to pay any income tax on the first six thousand dollars ($6,000) of service pay or allowances, nor shall any former member of the armed services of the United States be required to pay any income tax on any retirement pay or disability benefits received as a retired service member.
>
> (2) The compensation and benefits are declared exempt, to the extent of the first six thousand dollars ($6,000) thereof, from the state income tax.
>
> (3) All service pay or allowances and any retirement pay and disability benefits of members or former members of the armed services of the United States in excess of six thousand dollars ($6,000) per year shall be subject to the state income tax. However, all disability benefits received by disabled veterans of the armed services of the United States, regardless of the amount, shall be exempt from the Arkansas income tax.
>
> (b) Nothing in this section shall exempt from taxation the income of these persons derived from other sources than their service pay and allowances.
>
> (c) The term 'armed services' as used in this section, means any and all members of the United States Army, Navy, Marine Corps, Coast Guard, Air Force, and any and all other branches of the military and naval forces or auxiliaries."

Ark. Code Ann. § 26-51-307 (1987) provides in pertinent part:

> "(a) Except as provided by subsections (b) and (c)

of this section, the first six thousand dollars ($6,000) of retirement or disability benefits received after December 31, 1984, by any resident of this state from public or private employment-related retirement systems, plans, or programs, regardless of the method of funding for such systems, plans, or programs, shall be exempt from the state income tax.

(b) All retirement benefits, other than disability benefits, received by any resident of this state shall be exempt from the state income tax if:

(1) The recipient is entitled to receive the benefits on or before December 31, 1989; and

(2) The benefits are received from the Arkansas Public Employees Retirement System, The Arkansas Teacher's Retirement System, the Arkansas State Police Retirement System, or the Arkansas State Highway Employees Retirement System, or any other retirement system, the benefits of which were entirely exempt from the state income tax immediately prior to the adoption of this section.

(c) All disability retirement benefits received by any resident of this state shall be exempt from Arkansas tax if:

(1) The recipient is entitled to receive the benefits on or before December 31, 1989; and

(2) The benefits are received by disabled veterans of the armed services of the United States and benefits received from the Arkansas Public Employees Retirement System, the Arkansas Teacher's Retirement System, the Arkansas State Police Retirement System, the Arkansas State Highway Employees Retirement

System and any other retirement system, the disability benefits of which were entirely exempt from the state income tax immediately prior to the adoption of this section. . . ."

Ark. Code Ann. § 26-51-307 [as amended by Act 27 of 1989 (3rd Ex. Sess.)] provides in pertinent part:

"(a) The first six thousand dollars ($6,000) of retirement or disability benefits received after December 31, 1988, by any resident of this state from public or private employment-related retirement systems, plans, or programs, regardless of the method of funding for such systems, plans, or programs, shall be exempt from the state income tax.

(b)(1) Except as provided in subdivision (3) of this subsection, the exemption provided for in this section for benefits received from a public or private employment-related retirement or disability system, plan, or program shall be the only exemption from state income taxes allowed for retirement or disability benefits received from any publicly or privately supported system, plan, or program, excepting only benefits received under systems, plans, or programs which are by federal law exempt from state income taxes.

(2) Any resident of this state who prior to January 1, 1989, received both military retirement or disability pay and other retirement or disability benefits shall be entitled to claim only one (1) six thousand dollar deduction beginning with tax year 1989. . . ."

4 U.S.C. § 111 provides:

"The United States consents to the taxation of pay or compensation for personal service as an officer or

employee of the United States, a territory or possession or political subdivision thereof, the government of the District of Columbia, or an agency or instrumentality of one or more of the foregoing, by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation."

5 U.S.C. § 5532 provides in pertinent part:

". . .(b) A retired officer of a regular component of a uniformed service who holds a position is entitled to receive the full pay of the position, but during the period for which he receives pay, his retired or retainer pay shall be reduced to an annual rate equal to the first $2,000 of the retired or retainer pay plus one-half of the remainder, if any. . . ."

5 U.S.C. § 8312 provides in pertinent part:

"(a) An individual, or his survivor or beneficiary, may not be paid annuity or retired pay on the basis of the service of the individual which is creditable toward the annuity or retired pay, subject to the exceptions in section 8311(2) and (3) of this title, if the individual —

(1) was convicted, before, on, or after September 1, 1954, of an offense named by subsection (b) of this section, to the extent provided by that subsection; or

(2) was convicted, before, on, or after September 26, 1961, of an offense named by subsection (c) of this section, to the extent provided by that subsection. . . ."

10 U.S.C. § 688 provides in pertinent part:

"(a) Under regulations prescribed by the Secretary of Defense, a retired member of the Regular Army, Regular Navy, Regular Air Force, or Regular Marine Corps, a member of the Retired Reserve who has completed at least 20 years of active service, or a member of the Fleet Reserve or Fleet Marine Corps Reserve may be ordered to active duty by the Secretary of the military department concerned at any time. . . ."

10 U.S.C. § 772 provides in pertinent part:

"(c) A retired officer of the Army, Navy, Air Force, or Marine Corps may bear the title and wear the uniform of his retired grade. . . ."

10 U.S.C. § 802(a)(4) provides:

"(a) The following persons are subject to this chapter:

. . . (4) Retired members of a regular component of the armed forces who are entitled to pay . . ."

10 U.S.C. § 1074 provides in pertinent part:

". . .(b) Under joint regulations to be prescribed by the administering Secretaries, a member or former member of a uniformed service who is entitled to retired or retainer pay, or equivalent pay may, upon request, be given medical and dental care in any facility of any uniformed service, subject to the availability of space and facilities and the capabilities of the medical and dental staff. . . ."

10 U.S.C. § 1076 provides in pertinent part:

". . .(b) Under regulations to be prescribed jointly

by the Secretary of Defense and the Secretary of Health and Human Services, a dependent of a member or former member —

> (1) who is, or (if deceased) was at the time of his death, entitled to retired or retainer pay or equivalent pay; or
>
> (2) who died before attaining age 60 and at the time of his death (A) would have been eligible for retired pay under chapter 67 of this title but for the fact that he was under 60 years of age, and (B) had elected to participate in the Survivor Benefit Plan established under subchapter II of chapter 73 of this title;

may, upon request, be given the medical and dental care prescribed by section 1077 of this title in facilities of the uniformed services, subject to the availability of space and facilities and the capabilities of the medical and dental staff, except that a dependent of a member or former member described in clause (2) may not be given such medical or dental care until the date on which such member or former member would have attained age 60. . . ."

10 U.S.C. § 1461 provides in pertinent part:

"(a) There is established on the books of the Treasury a fund to be known as the Department of Defense Military Retirement Fund (hereinafter in this chapter referred to as the 'Fund'), which shall be administered by the Secretary of the Treasury. The Fund shall be used for the accumulation of funds in order to finance on an actuarially sound basis liabilities of the Department of Defense under military and survivor benefit programs. . . ."

37 U.S.C. § 801 provides in pertinent part:

"(b) Payment may not be made from any appropriation, for a period of three years after his name is placed on that list to an officer on a retired list of the Regular Army, the Regular Navy, the Regular Air Force, the Regular Marine Corps, the Regular Coast Guard, the National Oceanic and Atmospheric Administration, or the Public Health Service, who is engaged for himself or others in selling or contracting or negotiating to sell, supplies or war materials to an agency of the Department of Defense, the Coast Guard, the National Oceanic and Atmospheric Administration, or the Public Health Service. . . ."

(2)

No. 91-375

IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1991

JIM C. PLEDGER, DIRECTOR OF THE ARKANSAS DEPARTMENT OF FINANCE AND ADMINISTRATION, TIM LEATHERS, COMMISSIONER OF REVENUES, AND JIMMIE LOU FISHER, TREASURER OF THE STATE OF ARKANSAS.....*Petitioners*

VS.

STANLEY BOSNICK AND WILLA S. LINDSEY, GEORGE E. STEWART, DON LANE, JOHN SANDFORT, WILLIAM DAWSON BARLOW AND HANK GAJDA, ON BEHALF OF THEMSELVES AND ALL OTHER SIMILARLY SITUATED TAXPAYERS.....*Respondents*

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF ARKANSAS

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I. NO SUBSTANTIAL FEDERAL QUESTION IS PRESENTED UNDER *DAVIS* WHICH MERITS REVIEW ON WRIT OF CERTIORARI

A. The decision of the Arkansas Supreme Court on class certification issues does not present a federal question.

Petitioners presented to the Arkansas Supreme Court the issue of whether the trial court "erred in including within the certified class military retirees and retirees from other states' governmental agencies." *Pledger v. Bosnick*, 306 Ark. 45, 51, 811 S.W.2d 286 (1990). The Arkansas Supreme Court noted that "[t]he class certification order ... was an appealable order pursuant to Arkansas Rule of Appellate Procedure 2(a)(9)." *Id.* at 49. As such, that order should have been appealed at the time it was entered, but Petitioners failed to do so.[1] However, the Arkansas Supreme Court concluded that regardless of "whether the appellants failed to appeal that order in a timely manner, [the issue of timeliness] is moot" because the court found no error in the class certification. *Id.* This Court should not consider the issue raised in Section I of the Petition for Writ of Certiorari [hereinafter "Petition"] because it represents an improper attempt to transform a state law issue of class certification into a federal question.

B. No substantial federal question is presented by this case because application of the *Davis* test in Arkansas turns upon principles of state law.

After reviewing the history of intergovernmental tax immunity and 4 U.S.C. § 111, this Court reiterated in *Davis v. Michigan Dept. of Treasury*, 489 U.S. 803 (1989) "[t]he imposition of a heavier tax burden on [those who deal with one sovereign] than is imposed on [those who deal with the other] must be justified by

---

[1] Rule 4(a) of the Arkansas Rules of Appellate Procedure provides in relevant part: "Except as otherwise provided in subsequent sections of this rule, a notice of appeal shall be filed within thirty (30) days from the entry of the judgment, decree or order appealed from."

significant differences between the two classes." *Id.* at 815-16 (quoting *Phillips Chemical Co. v. Dumas Independent School Dist.*, 361 U.S. 376, 383 (1960)). The Court further noted that "[i]n determining whether this standard of justification has been met, it is inappropriate to rely solely on the mode of analysis developed in ... equal protection cases ... [because] where problems of intergovernmental tax immunity are involved 'the Government's interests must be weighed in the balance.' ... Instead, **the relevant inquiry is whether the inconsistent tax treatment is directly related to and justified by 'significant differences between the two classes.'**" *Davis*, 489 U.S. at 816 (emphasis added) (quoting *Phillips Chemical*, 361 U.S. at 383-85).

Military retirees and retirees of the State of Arkansas and its political subdivisions are similarly situated in that each belongs to the class of retired public officers or employees who leave active government service and receive retirement benefits based upon years of past service and rank or level of compensation obtained.[2] Since military retirees and retired state employees are similarly situated, then under applicable principles of intergovernmental tax immunity and 4 U.S.C. § 111, they "presumably should be taxed alike," *Phillips Chemical Co.*, 361 U.S. at 381, unless differential taxation is "directly related to **and** justified by significant differences between the two classes." *Davis*, 489 U.S. at 816 (citation omitted and

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[2] "Members of the Armed Forces who serve for a specified period, generally at least 20 years, may retire with a pension. 10 U.S.C. § 3911 *et seq.* (1982 ed. and Supp. V) (Army); § 6321 *et seq.* (Navy and Marine Corps.); § 8911 *et seq.* (Air Force)." *Mansell v. Mansell*, 490 U.S. 581 (1989). "The amount of retirement pay a veteran is eligible to receive is calculated according to the number of years served and the rank achieved. 10 U.S.C. §§ 3926 and 3991 (Army); §§ 6325-6327 (Navy and Marine Corps); § 8929 (Air Force)." *Mansell*, 490 U.S. at 583. *See also McCarty v. McCarty*, 453 U.S. 210, 214 (1981).

By comparison, members of the Arkansas Public Employees' Retirement System may retire after 30 years of service, regardless of age, or at age 60 after completing 20 years of service, or at age 65 after completing 10 years of service. Ark. Code Ann. § 24-4-508(a) (1987). The amount of retirement income a member of the Arkansas Public Employees' Retirement System receives is calculated according to the number of years of service and his or her average compensation. Ark. Code Ann. § 24-4-601(a) (1987).

emphasis added). Each of the two prongs of the *Davis* test must be satisfied before a discriminatory tax scheme can overcome the presumption of equal treatment recognized in *Phillips*.

The "direct relationship" requirement is not satisfied unless differential treatment is actually "based on" alleged differences between the two classes. *Phillips Chemical*, 361 U.S. at 384; *Davis*, 489 U.S. at 816. Like the offensive Michigan tax scheme struck down in *Davis*, Arkansas' tax exemptions discriminate solely based upon the source of payment.[3] No other distinguishing factor is set forth in Arkansas' tax exemption statute. No statute or legislative history establishes that the Arkansas legislature intended to single out military retired pay for discrimination because of any actual or perceived differences from other forms of retirement income. To the contrary, except for the income tax exemption favoring retired state government employees, the Arkansas legislature has historically treated all forms of retirement income, including military retired pay and civil service retirement, in the

---

[3] The Arkansas statute involved here stated in relevant part:

> (a) Except as provided by subsections (b) and (c) of this section, the first six thousand dollars ($6,000) of retirement or disability benefits received after December 31, 1984, by any resident of this state from public or private employment-related retirement systems, plans, or programs, regardless of the method of funding for such systems, plans, or programs, shall be exempt from the state income tax.
>
> (b) All retirement benefits, other than disability benefits, received by any resident of this state shall be exempt from the state income tax if: (1) The recipient is entitled to receive the benefits on or before December 31, 1989; and (2) The benefits are received from the Arkansas Public Employees Retirement System, The Arkansas Teacher's Retirement system, the Arkansas State Police retirement System, or the Arkansas State Highway Employees Retirement System, or any other retirement system, the benefits of which were entirely exempt from the state income tax immediately prior to the adoption of this section.

Ark. Code Ann. § 26-51-307(a) and (b).

same manner.[4] The complete absence of any evidence that the Arkansas legislature intended to or did discriminate against military retirees for any reason other than the source of the payment should end the inquiry. Otherwise, under Petitioners' approach of drawing distinctions not made by the legislature, States could essentially invoke and apply a rational basis test under the rubric of *Davis* despite the absence of any statutory authority or legislative history to support the alleged basis for the inconsistent tax treatment, a proposition this Court has rejected. *See Davis*, 489 U.S. at 816; *Phillips*, 361 U.S. at 385.

Nonetheless, Petitioners have asserted that the inconsistent tax treatment is based upon "the differing nature" of military retired pay rather than the source of compensation. Relying upon federal cases that characterized military retired pay for purposes of various federal statutes which have nothing to do with taxation or intergovernmental immunity, Petitioners assert that "military retirement pay is actually not a pension or deferred compensation, but constitutes reduced pay for reduced service." Petition at 8.[5] However, the Arkansas Supreme Court rejected this argument and held that military retired pay is deferred compensation for Arkansas income tax purposes. *Pledger v. Bosnick*, 306 Ark. 45, 53, 811 S.W.2d 286 (1991).[6] Since military retired pay is deferred

---

[4] It is also interesting to note that after *Davis* the Arkansas legislature repealed the exemption that had favored retired state employees and still made no attempt to draw a distinction between military retired pay and other forms of retirement income. Thus, Arkansas continues to treat military retired pay the same as all other forms of retirement income.

[5] Petitioners' assertion that military retired pay is not a pension or deferred compensation conflicts with other portions of their Petition which refer to military retired pay as a "pension" that is "earned" during the years a member of the armed forces serves on active duty. Petition at 12.

[6] Arkansas has legislatively and judicially treated military retired pay as a pension or deferred compensation for state income tax purposes and for domestic property purposes. For state income tax purposes the Arkansas legislature has incorporated by reference the Internal Revenue Code provisions regarding deductions for IRA contributions. Ark. Code Ann. § 26-51-414 (Cont. next page)

compensation under Arkansas law, no direct relationship exists between the discriminatory taxation of military retired pay and the difference asserted by Petitioners. This alleged difference is simply not recognized under applicable state law.[7]

Essentially, Petitioners are requesting this Court to disregard Arkansas' characterization and treatment of military retired pay as a form of deferred compensation for state income tax purposes and determine as a matter of federal law that military retired pay is "current compensation for reduced services". While the ultimate issue under *Davis* is a matter of federal law, its resolution turns initially upon subsidiary issues of state law which were resolved by the Arkansas Supreme Court in favor of the Respondents. Since the Arkansas Supreme Court has held that military retired pay is properly characterized and taxed under state law as deferred compensation rather than current compensation, Petitioners actually seek a re-examination of this settled question of state law, an inappropriate basis for *certiorari*.[8]

(Supp. 1991). The Internal Revenue Service has treated military retired pay as a pension or deferred compensation for purposes of applying limitations on IRA deductions. The Arkansas Supreme Court has treated military retired pay as a pension that may be divided as marital property in divorce proceedings. *See Young v. Young*, 288 Ark. 33, 701 S.W.2d 369 (1986); *Askins v. Askins*, 288 Ark. 333, 704 S.W.2d 632 (1986); *Womack v. Womack*, 16 Ark. App. 108, 697 S.W.2d 930 (1985).

[7] In other *Davis* related cases, the highest appellate courts of two other states have refused to distinguish military retired pay from civil service retirement benefits. *See Kuhn v. State of Colorado*, No. 90SA299, 90SA300, slip op. (Colo. Sept. 16, 1991) (WESTLAW, 1991 WL 179971); *Hackman v. Director of Revenue*, 771 S.W.2d 77 (Mo. 1989) (en banc), *cert. denied* 110 S.Ct. 718 (January 8, 1990).

[8] Federal law should not preempt state law in situations such as this, where state law has consistently characterized military retired pay as deferred compensation for state tax and domestic property matters and that characterization does not violate federal law. *See Hisquierdo v. Hisquierdo*, 439 U.S. 572, 581 (1974); *United States v. Yazell*, 382 U.S. 341, 352 (1966).

C. **Arkansas' exemption statute is overbroad as was the Michigan statute in *Davis*; therefore, it fails the direct relationship requirement.**

In addition to their argument that military retired pay is current compensation, Petitioners have asserted that the discriminatory tax treatment of military retired pay is justified by such factors as: (1) members of the Armed Forces may retire at relatively young ages after completing 20 years of active military duty, (2) some military retirees may be recalled to active duty, and (3) the Arkansas Income Tax Act affords favorable treatment to military personnel while serving on active duty. Even if Petitioners are permitted to speculate on possible reasons why the Arkansas legislature could have discriminated against military retirees, and assuming further that the Arkansas legislature actually chose to discriminate because of the existence of such differences, the blanket discrimination which Arkansas has imposed against all military retirees is overbroad and therefore is not directly related to any of the differences asserted by Petitioners.

The reasoning applied by the Court in *Davis* is directly on point. There the Court rejected Michigan's arguments that federal retirement benefits could be subjected to inconsistent tax treatment because they were significantly more munificent than State and local retirement benefits "in terms of vesting requirements, rate of accrual, and computation of benefit amounts." 489 U.S. at 816. In rejecting this argument, the Court concluded that Michigan's discriminatory statute was not directly related to such differences, reasoning in relevant part:

> A tax exemption truly intended to account for differences in retirement benefits would not discriminate on the basis of the source of those benefits, as Michigan's statute does; rather, it would discriminate on the basis of the amount of benefits received by individual retirees.

Id. at 817. Applying that reasoning here, if Arkansas' discriminatory tax exemption was truly intended to account for

differences in retirement ages, account for the fact that some military retirees may be recalled to active duty or account for the fact that some military retirees were afforded favorable income tax treatment while serving on active duty, it would not have discriminated on the basis of the source of benefits, as the Arkansas statute has done; rather, it would have discriminated on the basis of the age of individual retirees, on the basis of whether the individual retiree previously received the benefit of such favorable treatment while serving on active duty or on the basis of whether the individual retiree may be recalled to active duty. Arkansas' statute did none of these things.

Paraphrasing the *Davis* opinion's reference to federal civil service retirees: "While the average retired [military officer may be younger] than his state counterpart, there are undoubtedly many individual instances in which the opposite holds true." *Id.* Furthermore, while many military personnel have received and continue to receive the benefit of Arkansas' $6,000 exemption for active duty compensation, undoubtedly some military retirees moved to Arkansas after retiring from active military duty and have never received the benefit of Arkansas' exemption for active duty income.[9] Finally, while many military retirees are subject to being recalled to active duty, there are undoubtedly many who are not.[10]

Arkansas has discriminated against all military retirees regardless of their age, regardless of whether they benefited (or how much they benefited) from Arkansas' active duty exemption during

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[9] Military retirees who are subsequently employed in federal civil service may elect to apply their years of military service towards a civil service retirement plan. 5 C.F.R. § 831.301(a). The fact that Arkansas' statute draws no distinction between military retirees who have applied their years of military service to the civil service retirement plan further illustrates that the inconsistent tax treatment of military retirees is not directly related to the differences asserted by Petitioners.

[10] *See, e.g.*, 10 U.S.C.A. § 675 (Supp. 1991) (retired reserve officers and enlisted personnel may be recalled only "if qualified" for active duty). Arkansas' statute draws no distinction between those retirees who are subject to recall and those who are not.

the years they earned their pensions, and regardless of whether they are subject to being recalled to active duty. This type of blanket discrimination against all retired military is overbroad and therefore is not "directly related" to any of the differences asserted by Petitioners.

D. The discriminatory taxation of military retired pay is not "justified by significant differences."

The second prong of the analysis focuses on whether the discriminatory tax treatment of military retirees is "justified by significant differences between the two classes." *Davis*, 489 U.S. at 816 (quoting *Phillips Chemical Co. v. Dumas Independent School Dist.*, 361 U.S. at 383). Petitioners assert that military retired pay is significantly different from the retirement income paid to former State employees and civil service employees in that the latter is deferred compensation or a pension, while military retired pay is current compensation. Essentially, Petitioners equate military retired pay with the current compensation (*i.e.*, wages, salaries) that is paid to current employees of the State of Arkansas, current federal civil service employees and active duty members of the armed forces.

As support for their argument, Petitioners rely upon various federal cases that have treated military retired pay as "reduced pay for reduced services" for purposes of interpreting and applying certain federal statutes. However, none of those cases has characterized military retired pay as current compensation for income tax purposes or otherwise indicated that Congress intended for retired pay to be treated as such for that purpose. In fact, Congress has never referred to military retired pay as "reduced pay for reduced service." Rather, that phrase has been used by federal courts in cases that have interpreted and applied various federal statutes for non-tax purposes, but in no case has it been declared or even implied that such a characterization was intended to or would justify tax discrimination against the recipients of military retired pay.

Petitioners contend that this Court should hold that military retired pay **must in all cases** be deemed to be current pay for current (albeit reduced) work. Respondents submit, on the other hand, that compensation to military retirees does not **always** have to be **either** a pension **or** current pay. To the contrary, as this Court noted in *McCarty v. McCarty*, 453 U.S. 210 (1981), military retired pay has characteristics of **both** deferred compensation and current compensation. *Id.* at 223 n.16.

What matters in reaching a determination as to the appropriate characterization in a particular case is the **purpose** of the inquiry. Here, the purpose relates to the ability of a state to discriminate against employees of the federal government, hence the focus of the inquiry should be upon the similarities between the favored class (retirees from Arkansas governmental service) and the targets of the discriminatory treatment (military retirees). When this focus is kept in mind, the similarities between these two classes are overwhelming and the differences for the subject purpose are nothing more than afterthoughts and makeweights. The distinctions certainly are not of such a magnitude as to rise to the level of such "significant differences" as would justify discrimination against the military retirees, as required by *Davis*. This Court need not repaint this gray horse black or white. All it need do is recognize that there are insufficient differences between state and military retirees to justify discrimination against the latter.

A major factor to consider when deciding this issue is the manner in which Congress has treated military retired pay. Congress and the Internal Revenue Service ("IRS") have, for federal tax purposes, consistently treated military retired pay in the same manner as any other pension or deferred compensation. For example, in 1956 Congress amended the Social Security Act ["SSA"] and the Federal Insurance Contributions Act ["FICA"] to bring military personnel under the contributory system of social security in the United States. Pub. L. No. 84-881, 70 Stat. 870 (1956). *See* 42 U.S.C.A. §§ 409(d), 410(l) and (m) (Supp. 1991)

[hereinafter SSA]; 26 U.S.C.A. §§ 3121(m) and (n) (Supp. 1990) [hereinafter FICA].[11] One of the primary purposes of the Social Security system is to provide benefits upon retirement when employees no longer expect to receive significant amounts of compensation for their services.[12] Thus, Congress has funded the Social Security program through FICA taxes imposed on employers and employees based upon specified percentages of "the wages (as defined in section 3121(a)) received by [an individual] with respect to employment." 26 U.S.C.A. § 3101(a) (Supp. 1990). Congress has defined the term "wages" broadly to include "all remuneration for employment" unless otherwise excluded. 26 U.S.C.A. § 3121(a) (Supp. 1990).

In extending Social Security coverage to military personnel, Congress specified that "basic pay" for active duty service would be included in the term "wages" subject to FICA taxes, but did not include retired pay within the meaning of "wages" subject to FICA taxes. 26 U.S.C.A. § 3121(i)(2) (Supp. 1990). The significance of this is emphasized by the fact that Congress specifically included retired military in the definition of who is a "member of a uniformed service." 26 U.S.C.A. §§ 3121(m) and (n) (Supp. 1990).

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[11] The purpose of this legislation was to "cover military personnel into the contributory Social Security System, thereby supplementing military retirement and survivors benefits." S. Rep. No. 2380, 85th Cong., 2d Sess. 1, *reprinted in* 1956 U.S. Code Cong. & Admin. News 3976, 3977. For members of the federal military, "[c]ontributions and benefits [are the] same as civilian employment." House Select Comm. on Survivor Benefits, 84th Cong., 2d Sess., AN ANALYSIS OF PUBLIC LAW 881 (H.R. 7089) 5 (Comm. Print 1956). *See Survivor Benefit Act: Hearings on H. R. 7089 Before the Senate Comm. on Finance*, 84th Cong., 2d Sess. 60 (1956) (statement of Captain David L. Martineau) (regarding employee contributions, "military service personnel ... would be treated exactly the same as any other citizen who is now covered by social security.").

[12] Participants in the Social Security System become eligible to receive old age benefits at age 62; however, the amount of benefits they otherwise would be entitled to receive are reduced if the participant receives compensation "on account of work" in excess of specified levels. 42 U.S.C.S. § 403(b) (Supp. 1991).

If Congress had intended to treat military retired pay for tax purposes as current compensation for reduced services, as Petitioners assert, it would have included retired pay within the definition of "wages" and subjected retired pay to FICA taxes. To the contrary, Congress expressly recognized military retirees as "members of the uniformed services" but excluded their retired pay from the definition of "wages" subject to FICA tax. The reason military retired pay was not included in the term "wages" is that Congress does not consider it as wages for employment which should be taxed as current earnings or compensation. Thus, Congress has treated "basic pay" for active duty the same as all other forms of current compensation received by public and private sector employees that are subject to FICA taxes, while affording military retired pay the same tax treatment as all other retirement benefits that are paid to civilians including civil service retirement benefits, benefits paid by Arkansas' retirement systems, IRAs, SEPs and other types of qualified retirement plans. 26 U.S.C.A. §§ 3121(a)(5)(E) and (v)(3).

Petitioners' arguments are also in direct conflict with the fact that Congress and the IRS have treated military retired pay as a pension or deferred compensation for purposes of applying federal income tax provisions which limit the amount a taxpayer may claim as a deduction for contributions to an Individual Retirement Account ("IRA"). The amount which a taxpayer may contribute to an IRA and claim as a federal income tax deduction is limited to the lesser of $2,000 or *the amount of the taxpayer's compensation*. 26 U.S.C.A. § 219(a), (b) (Supp. 1991). The IRS has determined that government retirement benefits, including military retired pay, are not *compensation* within the meaning of the term as used by Congress in limiting IRA deductions, reasoning as follows:

> Section 1.219-1(c) of the Income Tax Regulations provides that the term 'compensation', for purposes of sections 219 and 220 of the Code, means wages, salaries, professional fees, or other amounts derived from or received from personal services actually rendered .... Congress has interpreted this regulation to mean that

> benefits received under a pension plan or other plan of deferred compensation is not compensation for purposes of sections 219 and 220 of the Code. See Staff of the Joint Committee on Taxation, 97th Cong. 2d Sess., General Explanation of the Economic Recovery Tax Act of 1981, (Comm. Print December 29, 1981), page 197, n.1.
>
> This interpretation is consistent with the legislative intent behind the enactment of the tax law relating to IRAs. **The purpose of an IRA is to give employees or self-employed individuals the opportunity to set aside some of their earnings for retirement.** See S. Rep. No. 93-383, 93d Cong. 1st Sess. 131 (1973), 1974-3 C.B. Supp. 210. **To base an IRA deduction upon contributions made with retirement pay would be inconsistent with this purpose.**

Priv. Ltr. Rul. 82-27-053 (Apr. 9, 1982) (emphasis added). M. Weinstein, MERTENS LAW OF FEDERAL INCOME TAXATION § 25C.12 at 58 (1988). The IRS has specifically determined in other letter rulings that the military retirement system is a **retirement plan** sponsored by government for the benefit of its employees. *See* Priv. Ltr. Rul. 87-25-094 (Mar. 30, 1987); Priv. Ltr. Rul. 80-07-048 (Nov. 21, 1979).

Congress has endorsed the IRS's reasoning by amending section 219(f)(1) to specifically exclude from the term "compensation" "any amount received as a pension or annuity [or] as deferred compensation." Technical Corrections Act of 1982, Pub. L. No. 97-448, § 103, 96 Stat 2365, 2375 (1983). Thus, Congress and the IRS have treated military retired pay as a pension or deferred compensation under the Internal Revenue Code for purposes of applying the limitations on IRA deductions. If Congress had intended military retired pay to be treated for tax purposes as "reduced compensation for reduced services," as Petitioners have asserted, then Congress would have included military retired pay in the meaning of "compensation" as used for calculating the amount which taxpayers may claim as an IRA deduction.

Considering the congressional treatment of military retired pay and the other similarities between military retirees and retired employees of the State of Arkansas both while in active government service and upon retirement, the following conclusions can be drawn:

1. Before retirement from active government service -- All such retirees received compensation for active service performed prior to retirement; all such retirees were equally subject to federal income taxation; all such retirees paid "employment taxes" on "wages" for employment under the Federal Insurance Contributions Act ("FICA," 26 U.S.C. § 3101 *et seq.*); all such retirees acquired legal interests in retirement pay capable of ownership as "property" and divisible as marital property upon dissolution of marriage; and all such retirees became eligible or qualified to receive retirement pay in accordance with years of service and highest position or rank attained.

2. Upon retirement from active service -- All such retirees left active government service; all such retirees acquired a "retired" status and received retirement or retired pay in accordance with their years of service and highest rank or position attained; all such retirees are prohibited from taking an IRA deduction under Internal Revenue Code § 219 and the Arkansas Income Tax Act as an offset against their retirement pay; all such retirees are exempt from paying "employment taxes" under FICA on retirement income since it does not qualify as "wages" for "employment" (*see* 26 U.S.C. § 3121(a)(5)); and all such retirees receive retirement income which is owned as property and divisible as marital property upon dissolution of marriage.

As the above demonstrates, even though military retired pay has characteristics of both deferred compensation and current compensation, the current compensation components of military retired pay do not amount to the type of "significant differences" that would "justify" discriminatory taxation of federal retirees in favor of retired state government employees. *Kuhn v. State of Colorado*, No. 90SA299, 90SA300, slip op. (Colo. Sept. 16, 1991) (WESTLAW, 1991 WL 179971). To paraphrase *Davis*: "It is

difficult to imagine that Congress consented to discriminatory taxation of the pensions of retired [members of the Armed Forces] while refusing to permit such taxation of [retired civil service] employees, and nothing in the statutory language or even in the legislative history [of 4 U.S.C. § 111] suggests this result." *Davis*, 489 U.S. at 810.[13]

In sum, under the principles of intergovernmental tax immunity, "a State may not single out those who deal with the Government, in one capacity or another, for a tax burden not imposed on others similarly situated." *Phillips*, 361 U.S. at 376. With respect to federal officers and employees, the doctrine is restated in 4 U.S.C. § 111, which prohibits discriminatory State taxation of "salaries, retirement benefits, and other forms of compensation ... on account of the source of the compensation." *Davis*, 489 U.S. at 810. Nothing in the doctrine or the statute differentiates between military and other federal employees. The nondiscrimination clause of 4 U.S.C. § 111 protects federal retirement benefits. "The danger that a State is engaging in impermissible discrimination against the Federal Government is greatest when the State acts to benefit itself and those in privity with it." *Davis*, 489 U.S. at 815 n.4. Thus, the State must "treat those who deal with the [Federal] Government as well as it treats those with whom it deals itself." *Phillips*, 361 U.S. at 385. The Arkansas Supreme Court correctly held that the Arkansas legislature has violated this cardinal rule.

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[13] Whatever the differences may be between military retired pay and other forms of public sector retirement income, they exist because Congress has created a military retirement system deemed necessary to our national defense. Consequently, any such differences result from the congressional exercise of constitutional power in furtherance of our national interests (U.S. Const. art. I, § 8, cls. 12, 13, 14 and 18), and do not qualify as a proper domestic concern of any state. Moreover, since Congress has not consented to discriminatory state taxation of military retired pay, such differential tax treatment clearly infringes upon and interferes with the military retirement system and, therefore, poses a threat to the attainment of its national objectives as recognized by this Court in *McCarty*, 453 U.S. at 232-35.

E. No substantial federal question is presented by the decision of the Arkansas Supreme Court holding that principles of intergovernmental tax immunity prohibit the State of Arkansas from discriminating against retired employees of other states, nor could such discrimination survive the equal protection challenge.

In *Collector v. Day*, 78 U.S. (11 Wall.) 113 (1871) this Court recognized that because States are independent sovereignties it must be implied that they are entitled to some type of immunity from taxation. Even though the broadest application of that decision was later limited, there still remains immunity which precludes discrimination. *Graves v. New York*, 306 U.S. 466 (1939). This immunity impliedly "arises from the constitutional structure and a concern for protecting state sovereignty." *South Carolina v. Baker*, 485 U.S. 505, 518 n.10 (1988).

The doctrine of "intergovernmental tax immunity is based on the need to protect **each sovereign's** governmental operations from undue interference by the other." *Davis v. Michigan Dept. of Treasury*, 489 U.S. at 814 (emphasis added) (citing *Graves*, 306 U.S. at 481, and *McCulloch v. Maryland*, 4 Wheat, at 435-436). The doctrine of intergovernmental tax immunity bars "those taxes that [are] imposed directly on one **sovereign** by the other or that discriminate ... against a **sovereign** or those with whom it dealt". *Davis*, 489 U.S. at 811 (emphasis added). "[T]he imposition of a heavier tax burden on those who deal with one **sovereign** than is imposed on those who deal with the other must be justified by significant differences between the two classes." *Davis*, 489 U.S. at 815-16 (citing *Phillips Chemical Co. v. Dumas Independent School Dist.*, 361 U.S. at 383) (emphasis added).

No substantial federal issue arises from the decision of the Arkansas Supreme Court to apply these principles of intergovernmental immunity to prohibit the State of Arkansas from discriminating against retired employees of another state.

Furthermore, even though the Arkansas Supreme Court did not

reach the issue, as this Court should not, the subject discrimination denied the retirees from other states Equal Protection under the Fourteenth Amendment since no **legitimate state purpose** would be promoted by allowing Arkansas to draw a distinction among government retirees based solely upon which government paid their retirement benefits. *Metropolitan Life Insurance Co. v. Ward*, 470 U.S. 869 (1985); *WHYY v. Glassboro*, 393 U.S. 117 (1968); *Wheeling Steel Corp. v. Gladner*, 337 U.S. 562 (1949).

II. NO SUBSTANTIAL FEDERAL QUESTION IS PRESENTED BY THE DECISION OF THE ARKANSAS SUPREME COURT TO PROVIDE RETROACTIVE RELIEF

A. No federal issue arises when a state chooses, as Arkansas has done, to provide relief from unconstitutional tax burdens, even if that relief is greater than federal law would require.

The trial court ordered the State of Arkansas to pay refunds pursuant to Arkansas' Tax Procedures Act (Ark. Code Ann. § 26-18-507(a) (1987)) without expressly engaging in an analysis under the three-prong test set out in *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971). On appeal to the Arkansas Supreme Court, Petitioners argued that the trial court erred by not applying a *Chevron* type of analysis to determine if *Davis* must be applied retroactively. Respondents contended that "regardless of the three *Chevron* factors" they were entitled to retroactive relief (*i.e.*, refunds) pursuant to the Arkansas Tax Procedures Act which provides for refunds of illegally exacted taxes and, since the Arkansas refund remedy complies with the mandate of *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 488 U.S. 954 (1990) to provide "meaningful backward looking relief," the state remedy should be applied without regard to retroactivity analysis. *Pledger v. Bosnick*, 306 Ark. 45, 55, 811 S.W.2d 286 (1991). The Arkansas Supreme Court concluded that, "[u]nder *either theory*, we hold that *Davis* ... must be applied retroactively." *Id.* Thus, the Arkansas Supreme Court affirmed the trial court's decision which ordered the state to pay refunds pursuant to Arkansas' tax refund

statute.[14]

"[F]ederal law sets certain minimum requirements that States must meet but may exceed in providing appropriate relief." *American Trucking Assns., Inc. v. Smith*, 110 S.Ct. 2323, 2331 (1990). "Although the Federal Constitution constrains the minimum remedy a State may provide ... it does not ordinarily limit the State's power to give a decision remedial effect greater than that which a federal court would provide." *Id.* at 2349 (Stevens, J., dissenting) (citations omitted). Thus, no federal issue arises when a state chooses, as Arkansas has done, to provide relief from an unconstitutional tax, even if that relief is greater than federal law would require.

B. Retroactivity is not an issue in statutory interpretation and application.

Davis construed and applied a federal statute, 4 U.S.C. § 111, originally enacted by Title I, Section 4 of the Public Salary Tax Act of 1939 (effective January 1, 1939). As thus construed, 4 U.S.C. § 111 has been "the supreme Law of the Land" since its effective date of January 1, 1939, and the import of *Davis* "is not to make a new law but only to hold that the law always meant what the court now says it means." *Fleming v. Fleming*, 264 U.S. 29, 31 (1924). As this Court in *Fleming* aptly recognized: "The court has power to construe a legislative act, but it has no power by change in construction to date its passage as a law from the time of the later decisions." *Id.* at 31-32 (1924). *Cf. Aloha Airline v. Director of Taxation of Hawaii*, 464 U.S. 7, 14 n.10 (1983).

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[14] Similarly, in other post-*Davis* related cases, the highest appellate courts of at least two other states have declined to engage in a *Chevron* analysis and have ordered tax refunds pursuant to state tax refund statutes reasoning that the refund rights granted under state refund law render such an analysis irrelevant to deciding a state law refund claim in state courts. *See Hackman v. Director of Revenue*, 771 S.W.2d 77 (Mo. 1989) (*en banc*), *cert. denied*, 110 S.Ct. 718 (1990) and *Kuhn v. State of Colorado*, No. 90SA299, 90SA300, slip op. (Colo. Sept. 16, 1991) (WESTLAW, 1991 WL 179971).

Under the *Fleming* principle there simply is no issue of retroactivity calling for a *Chevron* analysis. Arkansas' discriminatory tax scheme has always violated the 1939 federal statute, not from the date of the *Davis* decision but from the date of its adoption in 1971. There is, therefore, no occasion for consideration of retroactivity of *Davis*.

C. Any issue of retroactivity of *Davis* has been conclusively resolved.

Although there was no majority opinion for the Court in *James B. Beam Distilling Co. v. Georgia*, ___ U.S. ___, 111 S.Ct. 2439 (1991), six of the Justices agreed that a decision of the Court may not be applied retroactively in the case before it but only prospectively in other cases. That is, "when the Court has applied a rule of law to the litigants in one case, it must do so with respect to all others not barred by procedural requirements or res judicata." *Id.* at 2448.[15]

In *Davis*, the Court invalidated Michigan's discriminatory tax scheme as in effect during the tax years 1979 through 1984 and applied its decision to the litigants before it stating that "to the extent appellant has paid taxes pursuant to this invalid tax scheme, he is entitled to a refund," 109 S.Ct. at 1508-09 (citing *Iowa-Des Moines Bank v. Bennett*, 284 U.S. 239, 247 (1931)). Having accorded Paul Davis the benefit of the decision in *Davis*, that holding must be applied "to all others not barred by procedural

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[15] While the above quotation from Justice Souter's opinion, which Justice Stevens joined, does not purport to be the opinion of the Court, Respondents believe that it most succinctly states the minimum *common* opinion of the six Justices in the majority in *Beam*. *See id.* 111 S.Ct. at 2448 (White, J. concurring in the judgement) ("There [is] no precedent in civil cases applying a new rule to the parties in the case but not to others similarly situated"); *id.* at 2450 (Scalia, J., with whom Marshall and Blackmun JJ. joined, concurring in the judgement) ("I would find both 'selective prospectivity' and 'pure prospectivity' beyond our power"); *id.* at 2449 (Blackmun, J., with whom Marshall and Scalia, JJ. joined, concurring in the judgement) ("I conclude that prospectivity, whether 'selective' 'or pure' breaches our obligation to discharge our constitutional function.")

requirements or res judicata." *Beam*, 111 S.Ct. at 2448.

Petitioners assert that because Michigan conceded that a refund was an appropriate remedy in the event its statute was determined to be unconstitutional, this Court did not apply its decision in *Davis* to the parties before it, but "simply allowed state law to govern the issue" of retroactivity. Petition at 22. To the contrary, Michigan's concession that a refund was the proper choice of remedy for its unconstitutional tax is irrelevant to the federal choice of law question of whether *Davis* and 4 U.S.C. § 111 were, in the first instance, effective to invalidate Michigan's tax scheme as in effect during the tax years 1979 through 1984. This concession would have been of no consequence unless the Court as a matter of choice of law applied its ruling to the litigants before it.

The substantive question of the constitutionality of a tax and the remedial question arising upon its invalidation are two distinct issues. The remedial question would not have arisen in *Davis* unless the Court had applied its decision invalidating Michigan's taxes to the parties before it. All Michigan's concession did was agree to the requested remedy if it lost on the merits.[16] In fact, the plurality in *Beam* cited *Davis* as support for the proposition that, when the Court remands a case for consideration of remedial issues without reserving the question of retroactivity, it "necessarily implies that the precedential question has been settled to the effect that the rule of law will apply to the parties before the Court." *Beam*, 111 S.Ct. at 2445-2446. Accordingly, *Davis* is properly read as having applied the rule of law announced therein to the parties in that case.

Once having retroactively applied the rule of law announced in *Davis*, it is irrelevant how the Court arrived at its determination

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[16] Michigan did not merely concede that a refund was the appropriate remedy, it actually argued that, *if* its tax law was declared unconstitutional, a refund would be the proper *choice of remedy* rather than striking the exemption that favored state retirees and imposing a tax on them. *See* Brief for State of Michigan at 61-63, 82-83, *Davis v. Michigan*, 489 U.S. 802 (1989) (No. 87-1020).

to do so or even if it were correct in having done so. As the plurality made clear in *Beam*, whether the prospectivity issue was actually litigated and decided by the Court in *Davis* is "unnecessary" to the issue of whether *Davis* must be applied retroactively here. *Id.* at 2445 n.2. Justice White similarly noted that how or why the Court ended up applying its rule to the parties before it was irrelevant, stating: "even if ... the Court was quite wrong in doing so, that is water over the dam, irretrievably." *Id.* at 2248.

As the plurality stated in *Beam*, if the Court "did not reserve the question of whether its holding should be applied to the parties before it ... [the decision] is properly understood to have followed the normal rule of retroactive application in civil cases." *Id.* at 2445. Because there is a presumption of retroactivity, and because the *Davis* decision applied its ruling to the parties before it without purporting to reserve that question, the issue of the retroactivity of *Davis* has been conclusively resolved.[17]

D. Even if an analysis under *Chevron Oil* is appropriate, the Arkansas Supreme Court correctly held that *Davis* must be applied retroactively.

All three of the *Chevron* factors must be satisfied before the presumption of retroactivity can be overcome and *Davis* can be applied prospectively. Here, not even one of the *Chevron* factors which would justify departure from the rule of full retroactivity is satisfied.

"The first prong of the *Chevron Oil* test requires that 'the decision to be applied nonretroactively must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, or by deciding an issue of first impression, whose resolution was not clearly foreshadowed.'"

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[17] Thus, this Court vacated and remanded the decisions in *Harper v. Virginia Dept. of Taxation*, 401 S.E.2d 868, *vacated*, ___ U.S. ___, 111 S.Ct. 2883 (1991), and *Bass v. State of South Carolina*, 395 S.E.2d 171 (1990), *vacated*, ___ U.S. ___, 111 S.Ct. 2881 (1991) rendering Petitioners' reliance thereon misplaced.

Ashland Oil, Inc. v. Caryl, ___ U.S. ___, 110 S.Ct. 3202, 3204 (1990) (per curiam) (citation omitted) (quoting *Chevron*, 404 U.S. at 106-07). This is a threshold test which, if not satisfied, requires that a decision be applied retroactively. *Id.* at 3205.

Davis did not overrule past precedent of this Court nor did it decide an issue of first impression whose resolution was not clearly foreshadowed. To the contrary, *Davis* is replete with analysis and express language which unequivocally demonstrates that the law in this area has been clearly established and that the result in *Davis* was clearly foreshadowed. Accordingly, the threshold prong of the *Chevron* test has not been satisfied.

In resolving the question of statutory construction in *Davis* the Court stated:

> We have **no difficulty** concluding that civil service retirement benefits are deferred compensation for past years of service rendered to the Government .... **[T]he overall meaning of § 111 is unmistakable**: it waives whatever immunity past and present federal employees would otherwise enjoy from state taxation of salaries, retirement benefits and other forms of compensation paid on account of their employment with the Federal Government, except to the extent that such taxation discriminates on account of the source of compensation .... **Any other interpretation** of the nondiscrimination clause [in 4 U.S.C. § 111] **would be implausible at best**.

Davis, 489 U.S. at 808-10 (emphasis added).

In rejecting Michigan's argument "that the purpose of the [intergovernmental tax] immunity doctrine is to protect governments and not private entities or individuals" the *Davis* Court stated, **"Indeed, all precedent is to the contrary ... The State offers no reasons for departing from this settled rule, and we decline to do so."** *Id.* at 814-15 (emphasis added). The Court listed no fewer than five of its tax decisions dating back to 1842 in support of the

proposition that federal retirees may not be taxed discriminatorily and concluded its discussion of its precedents by noting:

> **As we observed in *Phillips Chemical Co.*,** 'it does not seem too much to require that the State treat those who deal with the Government as well as it treats those with whom it deals itself.'

Id. at 815 n.4 (emphasis added) (quoting *Phillips Chemical Co. v. Dumas Independent School Dist.*, 361 U.S. 376 (1960)).[18]

Davis "was not **revolutionary** ... nor [did it] decide a **wholly new issue** of first impression." *Ashland Oil, Inc. v. Caryl*, ___ U.S. ___, 110 S.Ct. 3202, 3205 (1990) (emphasis added). *See also National Mines Corporation v. Caryl*, ___ U.S. ___, 110 S.Ct. 3205 (1990). Indeed, *Davis* was, if anything, less "revolutionary" than this Court's decision in *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984) in which this Court unanimously applied retroactively last term in *Ashland Oil* and *National Mines*. Since *Davis* did not establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, or by deciding an issue of first impression whose resolution was not clearly foreshadowed, it does not clear the threshold hurdle of *Chevron* and must be applied retroactively.

The second prong of the *Chevron* test focuses on the purpose and effect of the constitutional rule in question and "whether retrospective operation will further or retard [the policies underlying] the rule in question." *Chevron*, 404 U.S. at 107. Here, those policies are to prevent "[t]he imposition of a heavier tax burden on [those who deal with one sovereign] than is imposed on [those who deal with the other]." *Davis*, 489 U.S. at 815-16. In the instant case, applying *Davis* retroactively will promote the doctrine of intergovernmental tax immunity and 4 U.S.C. § 111 in

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[18] *Phillips Chemical* was a 1960 decision that was decided eleven years prior to Arkansas' enactment of the first discriminatory exemption favoring state government employees over federal retirees.

two significant ways: (1) redressing the United States' and Respondents' federal statutory and constitutional injuries and (2) deterring future violations.

Relying upon *American Trucking Assns., Inc. v. Smith*, 483 U.S. 1014 (1990), Petitioners assert that "the purpose of [the doctrine of] intergovernmental tax immunity is not to prevent legitimate state taxation ..." and that "retroactive application of *Davis* would not further operation of the doctrine." Petition at 19. However, the factors that led the plurality in *Smith* to conclude that retroactive application of *American Trucking Assns., Inc. v. Scheiner*, 483 U.S. 266 (1987) would not deter future constitutional violations are not applicable here. In *Smith*, the plurality applied the following reasoning under the second prong of the *Chevron* test:

> *Scheiner* established a 'new principle of law' by **overruling** those aspects of the *Aero Mayflower* cases on which the State of Arkansas relied in enacting and assessing the HUE tax ... [T]he HUE tax was entirely consistent with the *Aero Mayflower* line of cases and it is not the purpose of the Commerce Clause to prevent legitimate state taxation of interstate commerce.

110 S.Ct. at 2332 (emphasis added).

Similarly the dissent in *Beam* applied the following reasoning to conclude that retroactive application of the Court's decision in *Bacchus* would not deter future constitutional violations:

> [*Bacchus*] came **out of the blue** ... **overruled** ... [prior precedents of this Court] and created a **new rule** .... Before our decision in *Bacchus*, the State of Georgia was fully justified in believing that the tax at issue in this case did not violate the Commerce Clause. Indeed, before *Bacchus* it did not violate the Commerce Clause. The imposition of liability **in hindsight** against a State that, acting reasonably would do the same thing again, will

> prevent no unconstitutionality .... Precisely because *Bacchus* was so **unprecedented**, the equities weigh heavily against retroactive application of the rule announced in that case.

Beam, 111 S.Ct. at 2455 (O'Connor, J., dissenting) (emphasis added).

Unlike *Scheiner* and (arguably) *Bacchus*, *Davis* did not overrule prior precedents of this Court; therefore, the reasoning that led the plurality in *Smith* and the dissent in *Beam* to conclude that retroactivity would not deter future constitutional violations is not applicable here.

Under Petitioners' approach to the second prong of the *Chevron* test, prospectivity would be the norm rather than the infrequent exception. In that situation, any impulse state legislators have to enact constitutionally dubious taxes would be reinforced by the knowledge that such preferences would be not only politically advantageous but economically cost-free. Accordingly, retroactive application of *Davis* will promote the federal constitutional interest in preventing future violations of the doctrine of intergovernmental immunity by placing state legislators at pains to avoid the evils forbidden by the doctrine of intergovernmental immunity and 4 U.S.C. § 111. *See Nippert v. City of Richmond*, 327 U.S. 416 (1946).

Retroactive application of *Davis* will also promote the purposes of the doctrine and 4 U.S.C. § 111 by enabling the federal government to recover, in part, the revenues it has lost in past years as the result of the discriminatory practices found unconstitutional in *Davis*. *See Davis*, 489 U.S. at 815 n.4. Unlawful state taxes have been paid and deducted under 26 U.S.C. § 164 on federal returns in past years by numerous federal retirees directly reducing federal income tax collections. The refunds to which these citizens are entitled are subject to federal income taxation under 26 U.S.C. § 111 and will now enable the federal government to recover, in part, those lost federal revenues.

Contrary to Petitioners' assertion, the fact that the Arkansas legislature has repealed the exemptions that had favored retired state employees has no bearing on the second prong issue of whether retroactive application of *Davis* would further or retard the purposes of the doctrine. The Arkansas legislature merely made a choice between two prospective remedies for the future: "withdrawal of benefits from the favored class" or "extension of benefits to the excluded class." *Davis*, 489 U.S. at 818. The action taken by the legislature in making the choice between prospective remedies did nothing to promote the constitutional interests in remedying past discrimination and deterring future violations of the doctrine of intergovernmental tax immunity.

When it amended the law in 1989, the Arkansas legislature chose to increase state revenues by capping the exemption for state retirees, thus improving the financial condition of the state, but it did nothing to remedy the past offense. Moreover, even the action taken was not solely because *Davis* was decided, but in fact it only occurred *after* the trial court in *this* case invalidated the Arkansas law and ordered refunds. Only retroactive application of *Davis* will further the purpose of the doctrine of intergovernmental tax immunity by discouraging its violation in the future. Otherwise, legislatures can discriminate at will and simply change the law prospectively when challenged, reaping and retaining the interim benefits of their unlawful legislation.

The third prong of the *Chevron* test focuses on the issue of whether retroactive application of *Davis* would produce "substantial inequitable results." *Chevron*, 404 U.S. at 107. The State of Arkansas did not rely on precedents of this Court in adopting its discriminatory tax scheme. **"Indeed, all precedent is to the contrary."** *Davis*, 489 U.S. at 814 (emphasis added). Unlike *Scheiner* and (arguably) *Bacchus*, *Davis* did not upset settled expectations emanating from previous decisions of this Court; thus, the reliance interests which persuaded the plurality in *Smith* and the dissent in *Beam* to conclude that it would be inequitable to apply *Scheiner* and *Bacchus* retroactively simply are not present here.

These circumstances pose a paradigmatic question: who should bear the burden associated with enactment of an unconstitutional tax, the group of taxpayers whose rights have been violated or all taxpayers of the state that imposed the tax? The citizens of Arkansas and other states have for many years received the benefit of increased government services and/or lower taxes as the result of the unconstitutional taxes.[19] Thus, it is not inequitable to require the citizens of such states to share the burden of remedying the constitutional violations that occurred in years which are not yet barred by the statute of limitations. Applying *Davis* retroactively will fairly "allocate any resulting financial loss to the inevitable costs of government borne by all the taxpayers [rather] than ... solely by those whose rights ... have been violated." *Owen v. City of Independence*, 445 U.S. 622, 655 (1980).

The Court reiterated in *McKesson v. Division of Alcoholic Beverages and Tobacco*, 488 U.S. 954 (1990) that states may limit their obligation to provide postdeprivation remedies through the use of statutes of limitations and by requiring payment under protest. *Id.* at 2250-55. The Arkansas legislature weighed the equities when it decided to provide taxpayers with the right to obtain tax refunds subject only to the requirement that they file a refund claim within the applicable statute of limitations period (normally three years). Ark. Code Ann. § 26-18-306(i). In doing so, the Arkansas legislature chose to waive the common law ability to require payment under protest as a prerequisite to obtaining a refund. Thus, there is nothing inequitable about requiring Arkansas and other similarly situated states to honor their commitments to provide taxpayers with postdeprivation remedies that were assured them at the time taxes were collected. It is not for the Court to second guess a decision of the Arkansas legislature to refund taxes even if the Constitution otherwise might not require it.

The fact that Arkansas' discriminatory scheme has been in

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[19] Arkansas has discriminated in favor of retired employees of the State of Arkansas since 1971.

effect for many years does not give rise to a reliance interest under *Chevron*. *See Ashland Oil v. Caryl*, 110 S.Ct. at 3205 n.*. Furthermore, the sheer number of states violating a Congressional or constitutional mandate has never been a proper justification for unlawful state enactments. *See South Carolina v. Baker*, 485 U.S. 505, 515 (1988). As the Arkansas Supreme Court observed below, retroactive application of *Davis* does not cause an inequitable result because that case was decided; rather there will be a burden imposed upon one side or the other because the Arkansas legislature passed an unconstitutional act. Since one side or the other must suffer, there is not an *avoidable* inequitable result; hence, the third *Chevron* prong is not met.

CONCLUSION

Wherefore, Respondents pray that Petitioners' Petition for Writ of Certiorari be denied.

Respectfully submitted,

October 2, 1991

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No. 91-375

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1991

JIM C. PLEDGER, DIRECTOR OF THE ARKANSAS DEPARTMENT OF FINANCE AND ADMINISTRATION, TIM LEATHERS, COMMISSIONER OF REVENUES, AND JIMMIE LOU FISHER, TREASURER OF THE STATE OF ARKANSAS ..... *Petitioners*

vs.

STANLEY BOSNICK AND WILLA S. LINDSEY, GEORGE E. STEWART, DON LANE, JOHN SANDFORT, WILLIAM DAWSON BARLOW AND HANK GAJDA, ON BEHALF OF THEMSELVES AND ALL OTHER SIMILARLY SITUATED TAXPAYERS ..... *Respondents*

PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF ARKANSAS

REPLY BRIEF OF PETITIONERS TO RESPONDENTS' BRIEF IN OPPOSITION

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RULES INVOLVED

Rule 2 of the Arkansas Rules of Appellate Procedure provides in pertinent part:

> (a) An appeal may be taken from a circuit, chancery, or probate court to the Arkansas Supreme Court from:
> . . . 9. An order certifying a case as a class action in accordance with ARCP Rule 23.
>
> (b) An appeal from any final order also brings up for review any intermediate order involving the merits and necessarily affecting the judgment.

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I.

THE ARKANSAS SUPREME COURT DID NOT DECIDE THIS CASE AS A MATTER OF STATE LAW REGARDING CLASS CERTIFICATION, BUT RATHER ON PRINCIPLES OF FEDERAL LAW.

On Page 1 of their Brief in Opposition, Respondents state that this Court should not consider the issue raised in Section I of the Petition "because it represents an improper

attempt to transform a state law issue of class certification into a federal question." In support of this proposition, Respondents have incorrectly stated Arkansas law as to the appealability of a class certification order. It is true that Rule 2(a)(9) of the Arkansas Rules of Appellate Procedure (ARAP) provides that an appeal of an order of class certification *may* be taken at the time of the entry of the order, even if it is entered prior to the entry of a final order on the merits of the case. Prior to the amendment of ARAP 2 in 1985, class orders could not be appealed before entry of a final order on the merits. However, ARAP 2(a)(9) does not state that a class order *must* be appealed when entered. A further examination of ARAP 2 supports this position.

ARAP 2(b) states that an appeal from any final order also brings up for review any intermediate order involving the merits and necessarily affecting the judgment. Historically, class orders have been treated as intermediate orders by the Arkansas Supreme Court, and that court has reviewed these orders along with final orders. See *Slade v. Gammill*, 226 Ark. 244, 289 S.W.2d 176 (1956); *Creekmore v. Izard*, 236 Ark. 558, 367 S.W.2d 419 (1963). The amendment of ARAP 2 in 1985 to allow for an immediate appeal of a class order did nothing to change the nature of such an order as an intermediate order, and such an order may also be appealed at the time of the entry of a final order on the merits.

Notwithstanding the above discussion, this part of the case was not decided on the issue of class certification, but rather on the basis of federal law. In their Petition, Petitioners have used the term "class" in the generic sense to get the point across that the doctrine of intergovernmental tax immunity should not be applied to grant a refund of income tax to military retirees or retirees from employment with other

states and their political subdivisions. This portion of the case transcends a mere class certification issue, because it actually concerns the application of federal law to these subclasses. It is obvious that the Arkansas Supreme Court was also using the term "class" in the generic sense when it stated:

> However, whether the appellants failed to appeal that order in a timely manner is moot because we affirm for the reasons set forth below. . . . (P. App. A-4)

The Arkansas Supreme Court then decides the case on the basis of federal law and precedents. Examined in the proper context, this passage refutes Respondents' argument that Petitioners are attempting to transform a mere state law issue of class certification into a federal question.

II.

THE EXTENSION OF THE DOCTRINE OF INTER-GOVERNMENTAL TAX IMMUNITY AND 4 U.S.C. §111 TO MILITARY RETIREES AND RETIREES FROM EMPLOYMENT WITH OTHER STATES AND THEIR POLITICAL SUBDIVISIONS BY THE ARKANSAS SUPREME COURT CONSTITUTES A DECISION OF AN IMPORTANT FEDERAL QUESTION.

The decision of the Arkansas Supreme Court to grant a refund of Arkansas Income Tax paid on the retirement income of military retirees and retirees from employment with other states and their political subdivisions clearly decides a federal question in a way that conflicts with decisions of federal courts and of another state court of last resort as to whether the tax discriminates on the basis of the source of the taxed income, and if so, whether there are significant differences between the two classes to justify such treatment.

The bare statement by Respondents that this case "turns upon principles of state law" (Resp. Br. 1) falls upon closer examination.

> Footnote 8 of Respondents' Brief in Opposition states:
>
> Federal law should not preempt state law in situations such as this, where state law has consistently characterized military retired pay as deferred compensation for state tax and domestic property matters and that characterization does not violate federal law. See *Hisquierdo v. Hisquierdo*, 439 U.S. 572, 581 (1974); *United States v. Yazell*, 382 U.S. 341, 352 (1966). (Resp. Br. 5)

However, this Court has intervened when questions of federal law are not adequately served by state court application. As was stated by this Court in *Yazell*, state interests should be overridden by the federal courts "where clear and substantial interests of the National Government, which cannot be served consistently with respect for such state interests, will suffer major damage if the state law is applied." (382 U.S. at 352)

It is undisputed that until recently, the doctrine of intergovernmental tax immunity had not been invoked in the manner in which the Arkansas Supreme Court has done in this case. It is the position of the Petitioners that this application of a federal statute and a federal constitutional doctrine by the state court threatens clear and substantial federal interests. This threat is made even more clear by the exact opposite result reached by the Kansas Supreme Court in *Barker v. Kansas*, 815 P.2d 46 (1991). In fact, this Court, in both *Hisquierdo* and *Yazell*, granted certiorari to examine such novel state entanglements with federal law. Therefore, it

is just as clear that certiorari should be granted in this case.

There is no conflict between Petitioners' use of the word "pension" on Page 12 of their Petition and the arguments espoused in said Petition, as is suggested in Footnote 5 of Respondents' Brief in Opposition. (Resp. Br. 4) The word "pension" is being used in the generic sense as that is the form in which it was used by the Arkansas Supreme Court. (P. App. A-9)

There has been no case on point cited for the proposition that the doctrine of intergovernmental tax immunity should be extended to retirees from employment with other states and their political subdivisions. Respondents' citation of *Davis v. Michigan Dept. of Treasury*, 489 U.S. 803 (1983) is misplaced, since *Davis* was dealing with a state's tax treatment of federal employees. Respondents' quote from *Davis* on Page 15 of their Brief in Opposition, when examined in light of the case it cited, *Phillips Chemical Co. v. Dumas Independent School Dist.*, 361 U.S. 376 (1960), is clearly taken out of context. In *Phillips*, this Court stated:

> The imposition of a heavier tax burden on lessees of federal property than is imposed on lessees of other exempt public property must be justified by significant differences between the two classes. (361 U.S. at 383)

When taken in the proper context, there is nothing in the cases cited by Respondents which supports their claim that the doctrine of intergovernmental tax immunity should be extended to other states' retirees. Furthermore, although Respondents have alleged an Equal Protection violation, the Arkansas Supreme Court made no such finding, and the issue

should not be brought up in response to this Petition.

III

AN IMPORTANT FEDERAL QUESTION IS PRESENTED BY THE DECISION OF THE ARKANSAS SUPREME COURT TO PROVIDE RETROACTIVE RELIEF.

The claim of Respondents that no substantial federal question is presented by the decision of the Arkansas Supreme Court to provide retroactive relief in this case is contradicted by the very fact that most of Respondents' Brief in Opposition is devoted to a discussion of the federal questions presented. Respondents' discussion of the application of the three-factor test used by this Court in *Chevron Oil Co. v. Huson*, 404 U.S. 97, 30 L.Ed.2d 296, 92 S.Ct. 349 (1971) is a prime example. In this discussion, Respondents only highlight the conflict posed by the Arkansas Supreme Court's decision and the decisions of the Supreme Courts of Virginia, South Carolina, and North Carolina.

In addressing the first prong of the *Chevron* test, Respondents state:

> *Davis* "was not revolutionary . . . nor [did it] decide a wholly new issue of first impression." *Ashland Oil, Inc. v. Caryl*, ___ U.S. ___, 110 S.Ct. 3202, 3205 (1990) (emphasis added) *See also National Mines Corporation v. Caryl*, ___ U.S. ___, 110 S.Ct. 3205 (1990). (Resp. Br. 22)

Neither *Ashland Oil* nor *National Mines* directly refers to *Davis* in particular, so the structure of this particular sentence in Respondents' Brief is misleading.

The analysis by Respondents of the second and third prongs of the *Chevron* test are contrary to the analysis made by the Supreme Court of Virginia in *Harper v. Virginia Dept. of Taxation* and *Lewy v. Virginia Dept. of Taxation*, 401 S.E.2d 868 (1991); the Supreme Court of South Carolina in *Bass v. South Carolina*, 395 S.E.2d 171 (1990); and the Supreme Court of North Carolina in *Swanson, et al. v. North Carolina, et al.*, Docket No. 64PA91-Wake (August 14, 1991), further illustrating the dramatic conflict created by the decision of the Arkansas Supreme Court. Although Respondents note that the decisions in *Harper* and *Bass* have been vacated and remanded, Respondents do not seem to recognize that these cases were not simply reversed, which would have supported their claim that Petitioners' reliance on these cases was "misplaced." (Resp. Br. 20, FN 17) Further, Respondents do not even bother to address the *Swanson* case, which was issued by the North Carolina Supreme Court *after* the *Harper* and *Bass* cases were remanded.

Respondents have argued that any issue of the retroactive or prospective application of *Davis* has been conclusively resolved by the case of *James B. Beam Distilling Co. v. Georgia*, 501 U.S. ___ , 115 L.Ed.2d 481, 111 S.Ct. 2439 (1991). At Page 19 of their Brief in Opposition, Respondents state:

> In fact, the plurality in *Beam* cited *Davis* as support for the proposition that, when the Court remands a case for consideration of remedial issues without reserving the question of retroactivity, it "necessarily implies that the precedential question has been settled to the effect that the rule of law will apply to the parties before the Court." *Beam*, 111 S.Ct. at 2445-2446. Accordingly, *Davis* is properly read as having applied the rule of law

announced therein to the parties in that case. (Resp. Br. 19)

A closer look must be taken at the "support" *Davis* lends to the proposition set forth by Respondents. *Davis* was one of several cases set forth in this passage, with all the rest listed as "see" and "see also." *Davis* was the only case cited as "cf.", which actually invites the reader to compare and contrast. The citation's relevance will usually be clear to the reader only if it is explained. Such an explanation of the relevance of *Davis* to the remedial issues in *Beam* is provided by the North Carolina Supreme Court in *Swanson*, and this explanation refutes Respondents' analysis of the citation of *Davis* in *Beam*.

CONCLUSION

Respondents' arguments have done nothing to diminish the importance which should be placed on a review of this case by this Court. In fact, Respondents' arguments only highlight the fact that there is a dramatic conflict between the decision of the Arkansas Supreme Court and the Supreme Courts of Virginia, South Carolina, North Carolina, and Kansas with regard to these issues, and that the Petition should be granted to directly address these issues in a way that will leave no doubt as to the proper application of the doctrine of intergovernmental tax immunity and the retroactive or prospective application of *Davis* in this instance. Therefore, certiorari should issue to the Supreme Court of Arkansas so that this Honorable Court may review and correct the decision below.

Respectfully submitted,

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